Michigan State Employees' Retirement System
A Pension Trust Fund of the State of Michigan

Comprehensive Annual Financial Report for the Fiscal Year Ended September 30, 2006

M S E R S

Prepared by:
Financial Services
for
Office of Retirement Services
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Table of Contents

INTRODUCTORY SECTION

Certificate of Achievement

Certificate of Achievement for Excellence in Financial Reporting

Presented to

Michigan State

Employees' Retirement System

For its Comprehensive Annual
Financial Report
for the Fiscal Year Ended
September 30, 2005

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.

GOVERNMENT FINANCE OFFICERS ASSOCIATION OF THE UNITED STATES AND CANADA CORPORATION SEAL CHICAGO

President

Executive Director

Public Pension Standards Award

PPCC

Public Pension Coordinating Council

Public Pension Standards

2006 Award

Presented to

Michigan Office of Retirement Services

In recognition of meeting professional standards for plan design and administration as set forth in the Public Pension Standards.

Presented by the Public Pension Coordinating Council, a confederation of

National Association of State Retirement Administrators (NASRA)
National Conference on Public Employee Retirement Systems (NCPERS)
National Council on Teacher Retirement (NCTR)

Alan H. Winkle

Alan H. Winkle
Program Administrator

Letter of Transmittal

State Employees' Retirement System
P.O. Box 30171
Lansing, Michigan 48909
Telephone 517-322-5103
Outside Lansing 1-800-381-5111

STATE OF MICHIGAN

JENNIFER M. GRANHOLM, Governor

DEPARTMENT OF MANAGEMENT AND BUDGET

December 8, 2006

The Honorable Jennifer M. Granholm
Governor, State of Michigan,

Members of the Legislature
State of Michigan,

Retirement Board Members
and
Members, Retirees and Beneficiaries

Ladies and Gentlemen:

We are pleased to present the comprehensive annual financial report of the Michigan State Employees' Retirement System (System) for fiscal year 2006.

INTRODUCTION TO REPORT

The System was established by legislation under Public Act 240 of 1943 (the Michigan State Employees' Retirement Act) and is administered by the Office of Retirement Services (ORS). The number of active and retired members and beneficiaries of the System and a list of participating employers is presented in Note 1 of the financial statements in the Financial Section of this report. The purpose of the System is to provide benefits for all State Employees. The services performed by the staff provide benefits to members.

Responsibility

Responsibility for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures, rests with the leadership team of the System. To the best of our knowledge and belief, the enclosed data is accurate in all material respects and is reported in a manner designed to present fairly the financial position and results of operations of the System.

Internal Control Structure

The leadership team of the System is responsible for maintaining adequate internal accounting controls designed to provide reasonable assurance that transactions are executed in accordance with management's general or specific authorization, and are recorded as necessary to maintain accountability for assets and to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America. The internal

Letter Of Transmittal (Continued)

control structure is designed to provide reasonable assurance regarding the safekeeping of assets and reliability of all financial records.

Independent Auditors

Andrews Hooper & Pavlik P.L.C., independent auditors, conducted an annual audit of the System. The independent auditor's report on the System's financial statements is included in the Financial Section of this report.

Statute requires an annual actuarial valuation be conducted. The purpose of the valuation is to evaluate the mortality, service, compensation and other financial experience of the System and to recommend employer-funding rates for the subsequent year. This annual actuarial valuation was completed by The Segal Company for the fiscal year ended September 30, 2005. Actuarial certification and supporting statistics are included in the Actuarial Section of this report.

Report

The 2006 comprehensive annual financial report is presented in five sections. The Introductory Section contains the transmittal letter and identifies the administrative organization and professional consultants used by the System. The Financial Section contains the independent auditor's report, management's discussion and analysis, financial statements and notes of the System and certain supplemental schedules. The Investment Section summarizes investment activities. The Actuarial Section contains the independent consulting actuary's certification, an outline of actuarial assumptions and methods, and other actuarial statistics. The Statistical Section contains statistical tables of significant data pertaining to the System.

Management's Discussion and Analysis (MD&A)

Generally Accepted Accounting Principles (GAAP) requires that management provide a narrative introduction, overview, and analysis to accompany the Basic Financial Statements in the form of MD&A. This letter of transmittal is intended to complement MD&A and should be read in conjunction with it. The MD&A can be found immediately following the Independent Auditor's Report.

PROFILE OF THE GOVERNMENT

The System was established by Public Act 240 of 1943 and is administered by a nine-member board under the direction of the Executive Secretary. Public Act 216 of 1974 eliminated the requirement for member contributions and provided for financing by legislative appropriation and investment earnings.

Effective March 31, 1997, Public Act 487 of 1996 closed the plan to new applicants. All new employees become members of the State's defined contribution plan. The public act also allows for returning employees and members who left state employment on or before March 31, 1997, to elect the defined benefit plan instead of the defined contribution plan.

ECONOMIC CONDITIONS AND OUTLOOK

Despite challenging economic times, the System continues to show strong performance.

Investments

The State Treasurer is the investment fiduciary and custodian of all investments of the System pursuant to State law. The primary investment objective is to maximize the rate of return on the total investment portfolio, consistent with a high degree of prudence and sufficient diversity to eliminate inordinate risks and to meet the actuarial assumption for the investment return rate. The investment activity for the year produced a total rate of return on the portfolio of 12.8%. For the last five years, the System has experienced an annualized rate of return of 8.0%. A summary of asset allocation and rates of return can be found in the Investment Section of this report.

Letter Of Transmittal (Continued)

Accounting System

Transactions of the System are reported on the accrual basis of accounting. Revenues are recorded when earned and expenses are recorded when incurred. Participants' benefits are recorded when payable by law. We believe the accounting and administrative internal controls established by the System provide reasonable assurance the System is carrying out its responsibilities in safeguarding its assets, in maintaining the reliability of financial records for preparing the financial statements, and in maintaining accountability for its assets.

Funding

Funds are derived from the excess of additions to plan net assets over deductions from plan net assets. Funds are accumulated by the System in order to meet future benefit obligations to retirees and beneficiaries. The percentage computed by dividing the actuarial value of assets by the actuarial accrued liability is referred to as the "funded ratio." This ratio provides an indication of the funding status of the System and generally, the greater this percentage, the stronger the System. Effective in fiscal year 2001, the System used the valuation from the previous fiscal year for this report. This approach is consistent with Governmental Accounting Standards Board (GASB) Statement Number 25. Consistent with this approach, the most recent actuarial valuation was performed as of September 30, 2005. The actuarial value of the assets and actuarial accrued liability of the System were $9.9 billion and $12.4 billion, respectively, resulting in a funded ratio of 79.8% on September 30, 2005. A historical perspective of funding levels for the System is presented on the Schedule of Funding Progress in the Required Supplementary Information in the Financial Section of this report.

Postemployment Benefits

The System also administers the postemployment health benefits (health, dental and vision) offered to retirees. The benefits are funded on a cash or "pay-as-you-go" basis. An actuarial valuation was completed as of September 30, 2005, to determine the actuarial accrued liability if the benefits were to be pre-funded. If these benefits were pre-funded, the actuarial accrued liability for these benefits would be approximately $6.6 billion and the employer contribution for health care benefits would be 24.0% of payroll. Only members of the defined benefit plan were included when calculating the actuarial accrued liability.

MAJOR GOALS ACCOMPLISHED

The Michigan Department of Management and Budget, Office of Retirement Services continues to be proactive in identifying and meeting the needs of our customers in a timely and cost-effective manner. Moving forward with our Vision ORS technology project, we implemented a number of solutions that streamline internal process functions, thereby freeing staff to provide more personal one-on-one interactions with customers. Our greatest gains this year came when we converted from our old pension system (CPP) to a new, leading-edge pension payment processing system (Clarety). The new system permits staff access to up-to-date customer information all in a single place and enables us to process pension payments daily instead of once a month, which allows initial pension payments to be issued faster. Other improvements are highlighted below.

Focus on our Customer

Planning and saving for retirement early in your career received significant emphasis as we interacted with our customers. We encouraged members to take a serious look at their retirement plans to help them be better prepared for a more secure and fulfilling experience when it is time to retire. We used a variety of easy to understand resources to deliver our messages. Building on our existing Life Stages retirement publications, we added materials to serve a wider range of customer needs. We included printed materials on leaving employment before retirement, disability benefits, and information needed after retirement. We redesigned our websites using a life stages approach, making it easier for customers to find the information they need, regardless of whether they're just starting their career or nearing retirement.

Letter Of Transmittal (Continued)

Pre-retirement meetings across the state continued to be offered to those nearing retirement eligibility, with 2,039 attending. Those who attended one of these meetings could schedule a personalized telephone appointment to address any specific questions or concerns they might have before retiring.

Most of our customers still view the telephone as their primary means of communicating; this year our Customer Service telephone center answered 216,650 calls. A growing number of customers have found email correspondence better meets their busy lifestyles as demonstrated by the 14,106 emails we responded to this year. Our Customer Service staff also provided face-to-face interaction with 5,387 individuals who visited our main office. Our Detroit office staff met with 2,903 customers who either scheduled an appointment or walked in with questions, and answered 5,606 telephone calls with customers.

Our customer base extends to employers also, and this year we continued enhancing these relationships through regular communications and updated support materials. To strengthen our rapport with our employers, we used email updates to stay in touch with our contacts.

Staying in touch with our customers, whether they are active employees, pension recipients, or employers, is a priority. For retirees, the *Connections* newsletter, published twice a year, offers an annual financial report summary plus other pertinent information about retirement. Our ongoing surveys assist us in assessing our customers' needs and their level of satisfaction.

Continuously Improve Processes

For the last several years, we have invested substantial time and effort to transform ORS into a leading edge process-based organization. This year we celebrated some of our milestones – our on-line employer reporting and pay-period reporting process is fully implemented and stabilized, and we converted to our new pension payment processing system without incident. Both of these process enhancements are paying off through increased efficiencies and improved services to our external customers as well as our staff.

With the implementation of our new technology enhancements, our work processes are changing, which opens the door for other process improvements. Recognizing this opportunity, our reengineering team began assessing how six of our present processes, consisting of 47 tasks, function and then identified gaps to be resolved, efficiencies to be gained, and savings to reap.

ORS' influence is seen at the national level as well. Because of its reputation, ORS has provided leadership to the Board of National Sector Public Health Care Roundtable. This organization was instrumental in convincing Congress to include public sector health plans in the group eligible to receive the Medicare Part D subsidy. This subsidy is worth about $103 million annually to the State and the schools.

Promote a Positive Work Environment

Like many other progressive organizations the need for change has become the norm rather than the exception. With the introduction of technology changes to our core processes, we needed to realign our organizational structure. Clear, straight-forward communications between mangers and employees eased the transition.

Management has fostered an open, positive work environment where employees feel they are valued and appreciated. They are empathetic and supportive of others, generously giving to those in need, whether it's donating blood to the Red Cross, volunteering for Habitat for Humanity, or making contributions to United Way, the local food banks, troops stationed in Iraq, holiday giving trees, or a coworker experiencing personal hardships.

Management encourages employees to live out the values of Integrity, Inclusion, Excellence, and Teamwork. This year we instituted an awards program similar to DMB's annual Excellence Awards program to recognize individuals in the categories of Leadership, Innovation, Every Day Hero, Living the Values, and Customer Service. From this group of honorees, who were also nominated for the DMB Excellence Awards, a team of five ORS employees was honored with DMB's Innovator award.

Letter Of Transmittal (Continued)

Optimize Technology

Since the recent implementation of our new technology we've identified other ways to enhance our operations. Imaging of current correspondence and documents expanded to include employer correspondence as well as member and retiree correspondence. We've also undertaken an extensive project to begin converting existing paper files to electronic images so staff can quickly access them with a few clicks of a mouse rather than waiting for a paper file to be pulled. As part of this conversion, we scanned 4,680,816 images this year, providing more electronic access to insurance information, death records, tax deferred payment agreements, and pending retiree documentation, and further reducing our reliance on paper documents.

Our Internet activity is expanding as we begin using it for video conferences for employers and pending retirees. This technology improves the reliability and quality of our video presentations. We continue to explore additional opportunities to deliver information to our customers in a fast, convenient, efficient way.

Future enhancements to our pension system continue to move forward. This year we completed the requirements gathering steps for web self service and automating the processing of our forms and letters by using bar coding to speed document handling and trigger work flow processes.

We've learned a number of lessons from past Vision ORS implementation efforts, and we've used this knowledge to help avoid these pitfalls as we move forward. We're writing better requirements in the initial stages and doing extensive testing of processes before upgrading our system, which has paid off in much smoother program deployments.

AWARDS AND ACKNOWLEDGEMENTS

Certificate of Achievement

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the System for its comprehensive annual financial report for the fiscal year ended September 30, 2005. 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 accounting principles generally accepted in the United States of America and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. The System has received a Certificate of Achievement for 15 consecutive years. We believe our current 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.

Public Pension Standards Award

The Public Pension Coordinating Council, a confederation of the National Association of State Retirement Administrators (NASRA), the National Conference on Public Employee Retirement Systems (NCPERS), and the National Council on Teacher Retirement (NCTR), awarded Michigan Office of Retirement Services (ORS) the Public Pension Standards Award for recognition of meeting professional standards for plan design and administration as set forth in the standards for fiscal year 2006. This is the third year ORS has achieved this distinction.

Acknowledgements

The preparation of this report was accomplished with the dedication and cooperation of many people. It is intended to provide complete and reliable information as a basis for making management decisions, as a means of determining compliance with legal provisions, and as a means for determining responsible stewardship of the funds of the System.

Letter Of Transmittal (Continued)

We would, therefore, like to express our appreciation for the assistance given by staff, the advisors and the many people who contributed to its preparation. We believe their combined efforts have produced a report that will enable employers and plan members to better evaluate and understand the Michigan State Employees' Retirement System. Their cooperation contributes significantly to the success of the System.

Sincerely,

Lisa Webb Sharpe, Director
Department of Management and Budget

Phillip J. Stoddard, Acting Director
Office of Retirement Services

INTRODUCTORY SECTION

Administrative Organization

Retirement Board Members *

Douglas Drake, Chair
Retiree Member
Term Expires July 31, 2007

H. David Dekker
Employee Member
Term Expires July 31, 2008

Calvin Frappier
Retiree Member
Term Expires July 31, 2009

George M. Elworth
Representing Attorney General
Statutory Member

Craig Murray
Representing Deputy Auditor General
Statutory Member

John Schoonmaker
Representing Commissioner of
Finance & Insurance Services
Statutory Member

D. Daniel McLellan
Representing State Personnel Director
Statutory Member

Mark Haas, Vice Chair
Representing State Treasurer
Statutory Member

Harry Posner
Employee Member
Term Expires July 31, 2009

* Statute provides that board members may continue to serve after their term expires until they are either replaced or reappointed.

Administrative Organization

Department of Management and Budget
Office of Retirement Services
P.O. Box 30171
Lansing, Michigan 48909-7671
517-322-5103
1-800-381-5111

Advisors and Consultants

Actuaries
Gabriel Roeder Smith & Co.
Alan Sonnanstine
Southfield, Michigan

The Segal Company
Michael J. Karlin, F.S.A., M.A.A.A.
New York, New York

Legal Advisor
Mike Cox
Attorney General
State of Michigan

Auditors
Thomas H. McTavish, C.P.A.
Auditor General
State of Michigan

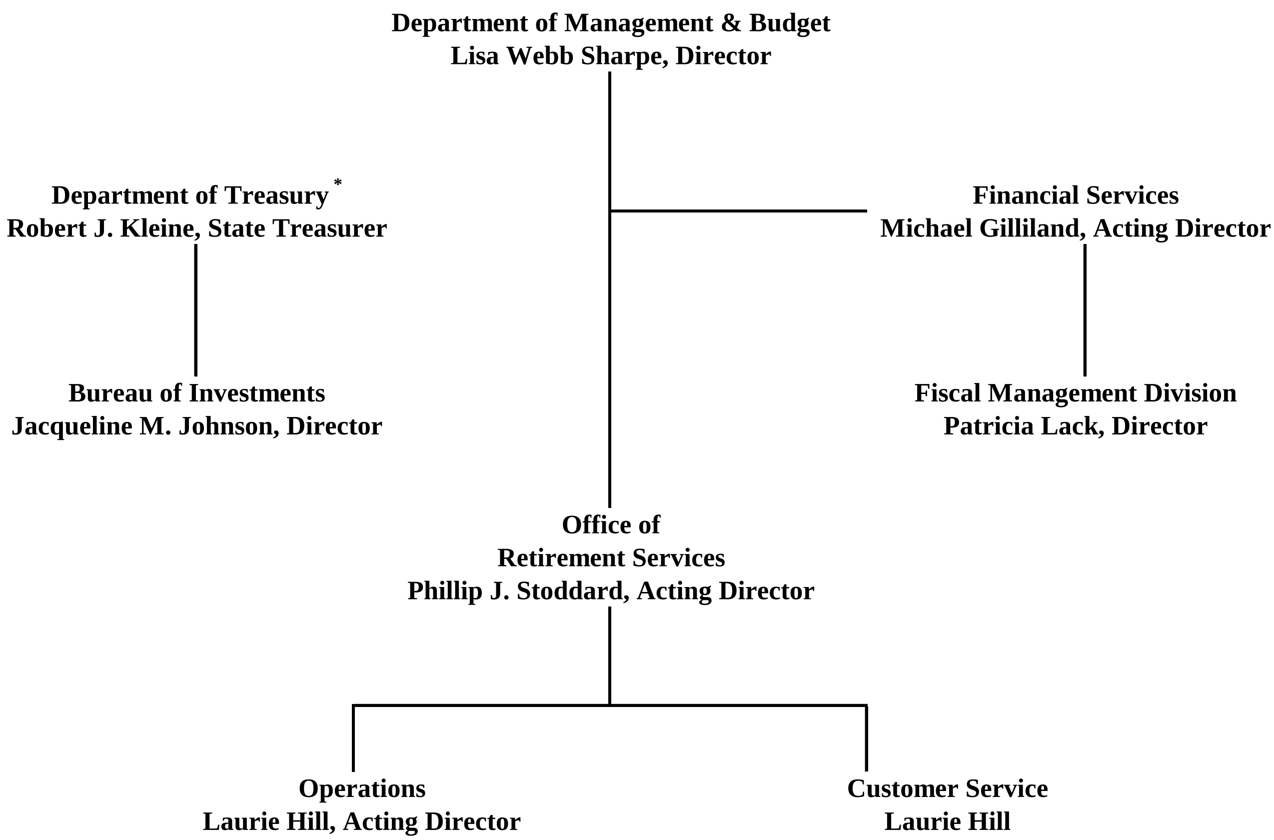
Andrews Hooper & Pavlik P.L.C.
Jeffrey J. Fineis, C.P.A.
Okemos, Michigan

Investment Manager and Custodian
Robert J. Kleine
State Treasurer
State of Michigan

Investment Performance Measurement
State Street Corporation
State Street Analytics
Boston, MA

Administrative Organization (Continued)

Organization Chart



*** The investments of the System are managed by the Michigan Department of Treasury. Information on the investments and the fiduciary, Michigan Department of Treasury, can be found in the Investment Section, Introduction. In addition, see the Investment Section, Schedule of Investment Fees and Schedule of Investment Commissions, for information regarding the investment fees and commissions paid as well as investment professionals utilized by the System.**

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FINANCIAL SECTION

Independent Auditor's Report
Management's Discussion and Analysis
Basic Financial Statements
Notes to Basic Financial Statements
Required Supplementary Information
Notes to Required Supplementary Information
Supporting Schedules

Financial Section

Independent Auditor's Report

ANDREWS HOOPER & PAVLIK P.L.C.
Certified Public Accountants

Ms. Lisa Webb Sharpe, Director, Department of Management and Budget
Mr. Phillip Stoddard, Acting Director, Office of Retirement Services
Mr. Thomas H. McTavish, CPA, Auditor General, Office of the Auditor General
Michigan State Employees' Retirement System Board

We have audited the accompanying statements of pension plan and postemployment healthcare plan net assets of the Michigan State Employees' Retirement System, as of September 30, 2006 and 2005, and the related statements of changes in pension plan and postemployment healthcare plan net assets for the years then ended. These financial statements are the responsibility of the management of the Michigan State Employees' Retirement System. 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 and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits 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, the financial status of the Michigan State Employees' Retirement System, as of September 30, 2006 and 2005, and the changes in its financial status for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 8, 2006 on our consideration of the Michigan State Employees' Retirement System's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in conjunction with this report in considering the results of our audit.

4295 Okemos Road, Suite 200 • Okemos, Michigan 48864 • 517.706.0800 fax 517.706.0011 • www.ahpplc.com

The Management's Discussion and Analysis (MD&A) is not a required part of the basic 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 this required supplemental information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The Introductory, Investment, Actuarial, and Statistical Sections and the required supplementary information and supporting schedules listed in the table of contents are presented for the purposes of additional analysis and are not a required part of the basic financial statements. The Introductory, Investment, Actuarial, and Statistical Sections and the required supplementary information and supporting schedules are the responsibility of the Michigan State Employees' Retirement System's management. The Schedules of Funding Progress and Employer Contributions and related notes and the supporting schedules have been subjected to the auditing procedures applied in our audits of the basic financial statements, and in our opinion, are fairly stated in all material respects when considered in relation to the basic financial statements taken as a whole. 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.

Andrews Hooper & Pavlik P.L.C.

Okemos, Michigan
December 8, 2006

*F*INANCIAL *S*ECTION

Management's Discussion and Analysis

Our discussion and analysis of the Michigan State Employees' Retirement System's (System) financial performance provides an overview of the System's financial activities for the fiscal year ended September 30, 2006. Please read it in conjunction with the transmittal letter in the Introductory Section on page 6 and the basic financial statements, which follow this discussion.

FINANCIAL HIGHLIGHTS

- System assets exceeded liabilities at the close of fiscal year 2006 by $11.0 billion (reported as *net assets*). Net assets are held in trust to meet future benefit payments.

- The System's funding objective is to meet long-term benefit obligations through contributions and investment income. As of September 30, 2005, the funded ratio was approximately 79.8%.

- Revenues for the year were $1,902.8 million, which is comprised of contributions of $648.3 million, investment gains of $1,254.3 million.

- Expenses increased in the current year from $1,074.1 million to $1,134.5 million or 5.6%. Most of this increase represented an increase in health care benefits paid.

THE STATEMENT OF PLAN NET ASSETS AND THE STATEMENT OF CHANGES IN PLAN NET ASSETS

This Comprehensive Annual Financial Report (CAFR) consists of two financial statements; *The Statements of Pension Plan and Postemployment Healthcare Plan Net Assets* (page 22) and *The Statements of Changes in Pension Plan and Postemployment Healthcare Plan Net Assets* (page 23*)*. These financial statements report information about the System, as a whole, and about its financial condition that should help answer the question: Is the System, as a whole, better off or worse off as a result of this year's activities? These statements include all assets and liabilities using the economic resources measurement focus and the accrual basis of accounting. Under the accrual basis of accounting, all revenues and expenses are taken into account regardless of when cash is received or paid.

The Statement of Pension Plan and Postemployment Healthcare Plan Net Assets presents all of the System's assets and liabilities, with the difference between the two reported as net assets. Over time, increases and decreases in net assets measure whether the System's financial position is improving or deteriorating. *The Statement of Changes in Pension Plan and Postemployment Healthcare Plan Net Assets* presents how the System's net assets changed during the most recent fiscal year. These two financial statements should be reviewed along with the Schedule of Funding Progress (page 41) and Schedule of Employer Contributions (page 42) to determine whether the System is becoming financially stronger or weaker and to understand changes over time in the funded status of the System.

Management's Discussion and Analysis (Continued)

FINANCIAL ANALYSIS

System total assets as of September 30, 2006, were $12.7 billion and were mostly comprised of cash, investments, and contributions due from employers. Total assets increased $1,900.7 million or 17.7% between fiscal years 2005 and 2006 primarily due to an increase of invested assets, and increased $727.2 million or 7.3% between fiscal years 2004 and 2005 primarily for the same reason.

Total liabilities as of September 30, 2006, were $1.7 billion and were mostly comprised of warrants outstanding, accounts payable, and obligations under securities lending. Total liabilities increased $1,132.3 million or 198.6% between fiscal years 2005 and 2006, and increased $8.0 million or 1.4% between fiscal years 2004 and 2005, primarily due to an increase in obligations under securities lending.

System assets exceeded its liabilities at the close of fiscal year 2006 by $11.0 billion, of which $41.3 million is for the Health Advance Funding SubAccount. Net assets for the Health Advance Funding Subaccount increased during 2006 by $7.4 million or 21.8%. Net assets held in trust for pension and health benefits increased $761.0 million or 7.5% between fiscal years 2005 and 2006, primarily due to investment earnings and contributions for the year exceeding total deductions of the System. Total net assets in fiscal year 2005 increased by $719.2 million or 7.6% from the prior year for reasons similar to those of the 2006 fiscal year.

Net Assets
(in thousands)

	2006	Increase (Decrease)	2005	Increase (Decrease)	2004
Assets					
Cash	$ 10,647	(50.4) %	$ 21,464	(42.5) %	$ 37,349
Receivables	117,440	(6.8)	125,976	25.4	100,430
Investments	12,524,335	18.1	10,604,278	7.3	9,886,693
Total Assets	12,652,422	17.7	10,751,718	7.3	10,024,472
Liabilities					
Warrants outstanding	1,728	3.7	1,666	(40.3)	2,790
Accounts payable and other accrued liabilities	1,649	5.4	1,564	24.6	1,255
Obligations under securities lending	1,699,065	199.7	566,873	1.6	558,059
Total Liabilities	1,702,442	198.6	570,103	1.4	562,104
Net Assets - Health Advance Funding SubAccount	41,304	21.8	33,905	(0.0)	33,905
Net Assets - Pension and Health Benefits	10,908,676	7.5	10,147,710	7.6	9,428,463
Total Net Assets	$ 10,949,980	7.5 %	$ 10,181,615	7.6 %	$ 9,462,368

Management's Discussion and Analysis (Continued)

REVENUES - ADDITIONS TO PLAN NET ASSETS

The reserves needed to finance retirement and health benefits are accumulated through the collection of employer contributions and through earnings on investments. Contributions and net investment income/(losses) for fiscal year 2006 totaled $1,902.8 million.

Total additions for fiscal year 2006 increased $109.5 million from those of fiscal year 2005 primarily due to investment earnings and increased employer contributions. Total additions increased $183.0 million between fiscal years 2004 and 2005 primarily for the same reasons. Total employer contributions increased between fiscal years 2005 and 2006 by $46.6 million or 8.0%, while member contributions decreased by $20.1 million or 49.0%. Total employer contributions increased between fiscal years 2004 and 2005 by $119.3 million or 25.9%, while member contributions decreased by $6.3 million or 13.3%.

The System is non-contributory; however, members may purchase service credit. The decrease in member contributions for fiscal year 2006 occurred because fewer individuals purchased service credit, similar to the decrease in member contributions between fiscal years 2004 and 2005. Net investment income increased between fiscal years 2005 and 2006 by $82.9 million. Net investment income increased between fiscal years 2004 and 2005 by $94.3 million. There were no Transfers from Pension/Health Benefit Plans between fiscal years 2005 and 2006. Similarly, the decision was also made not to make a transfer in 2005; thereby causing Transfers from Pension/Health Benefit Plans to decrease by $24.4 million or 100.0% between fiscal years 2004 and 2005. The notes to the financial statements describe these transfers in more detail. The Investment Section of this report reviews the results of investment activity for 2006.

EXPENSES - DEDUCTIONS FROM PLAN NET ASSETS

The primary expenses of the System include the payment of pension benefits to members and beneficiaries, payment for health, dental and vision benefits, refunds of contributions to former members, and the cost of administering the System. Total deductions for fiscal year 2006 were $1,134.5 million, an increase of 5.6% over fiscal year 2005 expenses. Total deductions for fiscal year 2005 were $1,074.1 million, a decrease of 3.6% over fiscal year 2004 expenses.

Payments for health care benefits to members and beneficiaries increased by $39.8 million or 12.3% from $322.8 million to $362.6 million during the fiscal year. This compares to a decrease of $31.8 million or 9.0% from $354.7 million to $322.8 million between fiscal years 2004 and 2005. The payment of pension benefits increased by $20.3 million or 2.7% between fiscal years 2005 and 2006 and by $15.7 million or 2.1% between fiscal years 2004 and 2005. In fiscal years 2006 and 2005, pension benefit expenses increased due to an increase in benefit payments to retirees and an increase of 179 retirees and 182 retirees, respectively. Refunds and transfers to other Plans or Systems decreased by $50 thousand or 16.3% between fiscal years 2005 and 2006. This compares to a decrease of $24.2 million or 98.7% between fiscal years 2004 and 2005. The notes to the financial statements describe these transfers in more detail. Administrative expenses increased by $330 thousand or 7.7% between fiscal years 2005 and 2006, primarily due to an increase in technological support. Administrative expenses decreased by $18 thousand or 0.4% between fiscal years 2004 and 2005, primarily due to a decrease in technological support.

Management's Discussion and Analysis (Continued)

Changes in Plan Net Assets
(in thousands)

	2006	Increase (Decrease)	2005	Increase (Decrease)	2004
Member contributions	$ 20,963	(49.0) %	$ 41,097	(13.3) %	$ 47,406
Employer contributions	627,379	8.0	580,738	25.9	461,428
Net investment income	1,254,277	7.1	1,171,402	8.8	1,077,138
Tranfers from other systems	123	2.5	120	361.5	26
Transfers from pension/health benefit plan	-	0.0	-	(100.0)	24,364
Miscellaneous income	106	5,200.0	2	0.0	2
Total Additions	1,902,848	6.1	1,793,359	11.4	1,610,364
Pension benefits	767,001	2.7	746,673	2.1	731,009
Health care benefits	362,597	12.3	322,834	(9.0)	354,650
Refunds of member contributions	254	(13.0)	292	79.1	163
Transfers to pension/health benefit plans	-	0.0	-	(100.0)	24,364
Tranfers to other systems	3	(80.0)	15	(25.0)	20
Administrative expenses	4,628	7.7	4,298	(0.4)	4,316
Total Deductions	1,134,483	5.6	1,074,112	(3.6)	1,114,522
Net Increase	768,365	6.8	719,247	45.1	495,842
Net Assets - Beginning of the year	10,181,615	7.6	9,462,368	5.5	8,966,526
Net Assets - End of Year	$ 10,949,980	7.5 %	$ 10,181,615	7.6 %	$ 9,462,368

RETIREMENT SYSTEM AS A WHOLE

The System's combined net assets experienced an increase for the fourth consecutive year, following a decrease in fiscal year 2002. This increase is a result of a moderate national economic upturn that resulted in investment income earnings. Management believes, and actuarial studies concur, that the System is in a financial position to meet its current obligations. We believe the current financial position has improved, in part, due to a prudent investment program, cost controls, and strategic planning.

CONTACTING SYSTEM FINANCIAL MANAGEMENT

This financial report is designed to provide the Retirement Board, our membership, taxpayers, investors, and creditors with a general overview of the System's finances and to demonstrate the System's accountability for the money it receives. If you have any questions about this report or need additional financial information, contact the Office of Retirement Services, P.O. Box 30171, Lansing, MI 48909-7671.

Statements of Pension Plan and Postemployment Healthcare Plan Net Assets

As of Fiscal Years Ending September 30, 2006 and 2005

	September 30, 2006			September 30, 2005		
	Pension Plan	Health Plan	Total	Pension Plan	Health Plan	Total
Assets:						
Equity in common cash	$ 10,588,129	$ 58,758	$ 10,646,887	$ 21,360,373	$ 103,611	$ 21,463,984
Receivables:						
Amounts due from employer	48,763,667	270,610	49,034,277	51,289,381	248,784	51,538,165
Amounts due from employer long term	68,101,263	-	68,101,263	74,359,877	-	74,359,877
Interest and dividends	303,054	1,682	304,736	77,633	377	78,010
Total receivables	117,167,984	272,292	117,440,276	125,726,891	249,161	125,976,052
Investments:						
Short term investment pools	231,794,399	1,286,326	233,080,725	347,422,005	1,685,204	349,107,209
Fixed income pools	1,753,282,015	9,729,712	1,763,011,727	1,604,333,030	7,781,970	1,612,115,000
Domestic equity pools	5,221,599,744	28,976,891	5,250,576,635	4,894,777,317	23,742,583	4,918,519,900
Real estate pool	941,152,425	5,222,857	946,375,282	852,012,815	4,132,769	856,145,584
Alternative investment pools	1,296,337,558	7,193,931	1,303,531,489	1,113,849,910	5,402,835	1,119,252,745
International equities pools	1,321,361,318	7,332,799	1,328,694,117	1,176,557,936	5,707,007	1,182,264,943
Cash Collateral on loaned securities	1,689,687,834	9,376,800	1,699,064,634	564,136,326	2,736,397	566,872,723
Total investments	12,455,215,293	69,119,316	12,524,334,609	10,553,089,339	51,188,765	10,604,278,104
Total assets	12,582,971,406	69,450,366	12,652,421,772	10,700,176,603	51,541,537	10,751,718,140
Liabilities:						
Warrants outstanding	1,718,213	9,535	1,727,748	1,658,030	8,042	1,666,072
Accounts payable and other accrued liabilities	1,640,132	9,102	1,649,234	1,556,583	7,550	1,564,133
Obligations under securities lending	1,689,687,834	9,376,800	1,699,064,634	564,136,327	2,736,397	566,872,724
Total liabilities	1,693,046,179	9,395,437	1,702,441,616	567,350,940	2,751,989	570,102,929
Net Assets - Health Advance Funding SubAccount	-	41,304,031	41,304,031		33,904,675	33,904,675
Net Assets - Pension and Health Benefits	10,889,925,227	18,750,898	10,908,676,125	10,132,825,663	14,884,873	10,147,710,536
Net Assets Held in Trust for Pension and Health Benefits*	$ 10,889,925,227	$ 60,054,929	$ 10,949,980,156	$ 10,132,825,663	$ 48,789,548	$ 10,181,615,211

*A schedule of funding progress is presented in the Required Supplementary Information in the Financial Section.

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

Statements of Changes in Pension Plan and Postemployment Healthcare Plan Net Assets

For Fiscal Years Ended September 30, 2006 and 2005

	September 30, 2006			September 30, 2005		
	Pension Plan	Health Plan	Total	Pension Plan	Health Plan	Total
Additions:						
Contributions:						
Member contributions	$ 9,434,310	$ 11,528,041	$ 20,962,351	$ 30,395,040	$ 10,701,614	$ 41,096,654
Employer contributions	270,705,017	356,674,243	627,379,260	256,433,052	324,305,023	580,738,075
Total contributions	280,139,327	368,202,284	648,341,611	286,828,092	335,006,637	621,834,729
Investment income (loss):						
Investment income (loss)	1,260,667,439	-	1,260,667,439	1,181,213,139	-	1,181,213,139
Interest income	-	5,660,782	5,660,782	-	2,712,374	2,712,374
Investment expenses:						
Real estate operating expenses	(94,039)	-	(94,039)	(152,515)	-	(152,515)
Other investment expenses	(13,449,226)	-	(13,449,226)	(13,165,031)	-	(13,165,031)
Securities lending activities:						
Securities lending income	39,745,998	-	39,745,998	14,504,416	-	14,504,416
Securities lending expenses	(38,253,881)	-	(38,253,881)	(13,710,240)	-	(13,710,240)
Net investment income (loss)	1,248,616,291	5,660,782	1,254,277,073	1,168,689,769	2,712,374	1,171,402,143
Transfers from other systems	123,059	-	123,059	119,594	-	119,594
Miscellaneous income	106,169	-	106,169	2,575	-	2,575
Total additions	1,528,984,846	373,863,066	1,902,847,912	1,455,640,030	337,719,011	1,793,359,041
Deductions:						
Benefits paid to plan members and beneficiaries:						
Retirement benefits	767,000,706	-	767,000,706	746,673,263	-	746,673,263
Health benefits	-	328,528,595	328,528,595	-	295,431,830	295,431,830
Dental/vision benefits	-	34,069,090	34,069,090	-	27,402,308	27,402,308
Refunds of member contributions	253,886	-	253,886	291,592	-	291,592
Transfers to other systems	2,647	-	2,647	15,051	-	15,051
Administrative expenses	4,628,043	-	4,628,043	4,297,985	-	4,297,985
Total deductions	771,885,282	362,597,685	1,134,482,967	751,277,891	322,834,138	1,074,112,029
Net Increase (Decrease)	757,099,564	11,265,381	768,364,945	704,362,139	14,884,873	719,247,012
Net Assets Held in Trust for Pension and Health Benefits:						
Beginning of Year	10,132,825,663	48,789,548	10,181,615,211	9,428,463,524	33,904,675	9,462,368,199
End of Year*	$ 10,889,925,227	$ 60,054,929	$ 10,949,980,156	$ 10,132,825,663	$ 48,789,548	$ 10,181,615,211

*A schedule of funding progress is presented in the Required Supplementary Information in the Financial Section.

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

Notes to Basic Financial Statements

NOTE 1 - PLAN DESCRIPTION

ORGANIZATION

The Michigan State Employees' Retirement System (System) is a single-employer, state-wide, defined benefit public employee retirement plan governed by the State of Michigan (State) and created under Public Act 240 of 1943, as amended. The System was established by the State to provide retirement, survivor and disability benefits to the State's government employees. The System is a qualified pension trust fund under section 401(a) of the Internal Revenue Code. By statute, employees of the following employers are also covered by this plan: American Legion, American Veterans, Veterans of Foreign Wars, Disabled American Veterans, Mackinac Island State Park, Marine Corps League, Michigan Bar Association, Military Order of the Purple Heart, Commission for Independent Vendors, Third Circuit Court, Recorders Court and 36th District Court. Michigan judges and elected officials, legislators, National Guard and state police officers are covered by separate retirement plans. Although the System reports information for several small employers, the State is legally responsible for almost all contractually required contributions to the System. This level of responsibility is ongoing and is unlikely to change significantly in the foreseeable future. Therefore, the reporting requirements for a single employer plan have been adopted.

The System's financial statements are included as a pension trust fund in the combined financial statements of the State.

The System is administered by the Office of Retirement Services, within the Michigan Department of Management and Budget. The Department Director appoints the Office Director who serves as Executive Secretary to the System's Board, with whom the general oversight of the System resides. The State Treasurer serves as the investment officer and custodian for the System.

MEMBERSHIP

At September 30, 2006 and 2005, the System's membership consisted of the following:

Retirees and beneficiaries currently receiving benefits:	**2006**	**2005**
Regular benefits	36,271	36,410
Survivor benefits	6,121	5,866
Disability benefits	3,588	3,525
Total	45,980	45,801
Current employees:		
Vested	31,161	30,974
Non-vested	1,414	2,796
Total	32,575	33,770
Inactive employees entitled to benefits and not yet receiving them	7,217	7,200
Total all members	85,772	86,771

Enrollment in the health plan is voluntary. The number of participants is as follows:

Health/Dental/Vision Plan	**2006**	**2005**
Eligible participants	45,980	45,801
Participants receiving benefits:		
Health	41,799	41,391
Dental	41,702	41,269
Vision	41,806	41,382

Notes to Basic Financial Statements (Continued)

At September 30, 2003, the System recognized 116 participants in the Defined Contribution (DC) Plan who elected to retire under the Early Out Retirement program. This program provided a .25% incentive for those DC members who qualified, which will be provided by the System. These 116 participants have not been included in the pension membership schedule on the previous page.

BENEFIT PROVISIONS

Introduction

Benefit provisions of the defined benefit pension plan are established by State statute, which may be amended. Public Act 240 of 1943, as amended, establishes eligibility and benefit provisions for the defined benefit pension plan. Retirement benefits are determined by final average compensation and years of service. Members are eligible to receive a monthly benefit when they meet certain age and service requirements. The System also provides duty disability, non-duty disability and survivor benefits.

A member who has separated from employment may request a refund of his or her member contribution account. The System is currently non-contributory. A refund may cancel a former member’s rights to future benefits. However, former members who return to employment and who previously received a refund of their contributions may reinstate their service through repayment of the refund upon satisfaction of certain requirements.

Effective March 31, 1997, Public Act 487 of 1996 closed the plan to new entrants. All new employees become members of the defined contribution plan. The Public Act allows returning employees and members who left State employment on or before March 31, 1997, to elect the defined benefit plan instead of the defined contribution plan.

Regular Retirement

The retirement benefit is based on a member’s years of credited service (employment) and final average compensation. The normal benefit equals 1.5% of a member’s final average compensation multiplied by the years and partial year of credited service and is payable monthly over the member’s lifetime.

Final average compensation is the average of a member’s monthly pay during 36 consecutive months of credited service. The 36 consecutive month period producing the highest monthly average is used. For most members, this is the last three years of employment.

A member may retire and receive a monthly benefit after attaining:

1. age 60 with 10 or more years of credited service; or
2. age 55 with 30 or more years of credited service; or
3. age 55 with at least 15 but less than 30 years of credited service. The benefit allowance is permanently reduced 0.5% for each month from the member’s age on the effective date of retirement to the date the member will attain age 60.

Employees in covered positions are eligible for supplemental benefits and may retire after attaining:

1. age 51 with 25 or more years in a covered position; or
2. age 56 with 10 or more years in a covered position.

In either case, the three years immediately preceding retirement must have been in a covered position. Employees in covered positions are responsible for the custody and supervision of inmates.

Employees of closing Department of Community Health facilities are eligible for retirement under one of the following conditions:

1. age 51 with 25 years of service, the last 5 of which were rendered in the closing facility;
2. age 56 with 10 years of service, the last 5 of which were rendered in the closing facility; or
3. 25 years of service at the closing facility regardless of age.

Notes to Basic Financial Statements (Continued)

Employees of the State Accident Fund, Michigan Biologic Products, or Liquor Control Commission who were terminated as the result of privatization may retire if the member's age and length of service was equal to or greater than 70 on the date of transfer or termination.

Conservation Officers (CO) with a hire date on or before April 1, 1991, are eligible to retire after 25 years of service, 20 of which must have been rendered as a CO. COs hired after April 1, 1991, and before March 31, 1997, must have 23 years of service as a CO to be eligible for a full retirement with only 25 years of service. In either case, 2 years immediately preceding retirement must be as a CO.

Deferred Retirement

Any member with 10 or more years of credited service who terminates employment but has not reached the age of retirement is a deferred member and is entitled to receive a monthly pension upon reaching age 60, provided the member's accumulated contributions have not been refunded. Deferred retirement is available after 5 years of service for State employees occupying unclassified positions in the executive and legislative branches and certain Department of Community Health employees subject to reduction in force lay-offs by reason of deinstitutionalization.

Non-Duty Disability Benefit

A member with 10 or more years of credited service who becomes totally and permanently disabled not due to performing duties as a State employee is eligible for a non-duty disability pension. The non-duty disability benefit is computed in the same manner as an age and service allowance based upon service and salary at the time of disability.

Duty Disability Benefit

A member who becomes totally and permanently disabled from performing duties as a State employee as a direct result of State employment and who has not met the age and service requirement for a regular pension, is eligible for a duty disability pension. Public Act 109 of 2004 amended the State Employees' Retirement Act to change the calculation of the pension benefit and increase the minimum annual payment. If the member is under age 60, the duty disability allowance is now a minimum of $6,000 payable annually. At age 60 the benefit is recomputed under service retirement.

Survivor Benefit

Upon the death of a member who was vested, the surviving spouse shall receive a benefit calculated as if the member had retired the day before the date of death and selected a survivor pension. Certain designated beneficiaries can be named to receive a survivor benefit. Public Act 109 of 2004 amended the State Employees' Retirement Act to change the calculation of Duty Death benefits and redefines eligibility for deceased member's survivors. The new minimum duty-related death benefit has been increased to $6,000.

Pension Payment Options

When applying for retirement, an employee may name a person other than his or her spouse as a beneficiary if the spouse waives this right. If a beneficiary is named, the employee must choose whether the beneficiary will receive 100%, 75% or 50% of the retiree's pension benefit after the retiree's death. The decision is irrevocable. A description of the options follows.

<u>Regular Pension</u> — The pension benefit is computed with no beneficiary rights. If the retiree made contributions while an employee and has not received the total accumulated contributions before death, a refund of the balance of the contributions is made to the beneficiary of record. If the retiree did not make any contributions, there will not be payments to beneficiaries.

<u>100% Survivor Pension</u> — Under this option, after the retiree's death, the beneficiary will receive 100% of the pension for the remainder of the beneficiary's lifetime. If this option is elected, the normal retirement benefit is reduced by a factor based upon the ages of the retiree and of the beneficiary. If the beneficiary predeceases the retiree, the pension "pops-up" to the regular pension amount; another beneficiary cannot be named.

Notes to Basic Financial Statements (Continued)

75% Survivor Pension - Under this option, after the retiree's death, the beneficiary will receive 75% of the pension for the remainder of the beneficiary's lifetime. If this option is elected, the normal retirement benefit is reduced by a factor based upon the ages of the retiree and of the beneficiary. If the beneficiary predeceases the retiree, the pension "pops-up" to the regular pension amount; another beneficiary cannot be named.

50% Survivor Pension — Under this option, after the retiree's death, the beneficiary will receive 50% of the pension for the remainder of the beneficiary's lifetime. If this option is elected, the normal retirement benefit is reduced by a factor based upon the ages of the retiree and of the beneficiary. The reduction factor is lower than the factor used in the 100% or 75% option previously described. If the beneficiary predeceases the retiree, the pension "pops-up" to the regular pension amount; another beneficiary cannot be named.

Equated Pension — An equated pension may be chosen by any member under age 65 except a disability retiree and an early supplemental retiree. Equated pensions provide an additional amount until age 65 and may be combined with Regular, 100%, 75% or 50% option. At age 65 the monthly amount is permanently reduced. The initial and reduced amounts are based on an estimate of social security benefits at age 65, provided by the Social Security Administration Office. In order to calculate this benefit, members choosing this option must provide ORS with an estimate from the Social Security Administration Office. The actual amount received from social security may vary from the estimate.

Post Retirement Adjustments

One-time upward benefit adjustments were made in 1972, 1974, 1976, 1977 and 1987. Beginning October 1, 1988, a 3% non-compounding increase, up to a maximum of $25 monthly, is paid each October to recipients who have been retired 12 full months. Beginning in 1983, eligible benefit recipients share in a distribution of investment income earned in excess of 8% annually. This distribution is known as the supplemental payment. The supplemental payment is offset by one year's cumulative increases received after the implementation of the annual 3% increase in benefits. These adjustment payments were not issued during fiscal years 1991 through 1994. Members who retired on or after October 1, 1987, are not eligible for the supplemental payment.

Contributions

Member Contributions — Members currently participate in the System on a noncontributory basis. Under certain circumstances, members may contribute to the System for the purchase of creditable service, such as military service or maternity leave, or a universal buy-in. If a member terminates the System employment before a retirement benefit is payable, the member's contribution and interest on deposit may be refunded. If the member dies before being vested, the member's contribution and interest are refunded to the designated beneficiaries.

Employer Contributions — The statute requires the employer to contribute to finance the benefits of plan members. These employer contributions are determined annually by the System's actuary and are based upon level-percent-of-payroll funding principles so the contribution rates do not have to increase over time.

Transfers to Defined Contribution Plan

During fiscal year 1998, the Michigan State Employees' Retirement Act provided members an opportunity to transfer to the Defined Contribution Plan. This was a one-time opportunity and the decision is irrevocable. The transfer must have been completed by September 30, 1998. With the passage of the legislation permitting the transfer, the System also became a closed system. All new employees are members of the Defined Contribution Plan.

Other Postemployment Benefits

Under the Michigan State Employees' Retirement Act, all retirees have the option of receiving health, prescription, dental, and vision coverage. The employer funds health benefits on a pay-as-you-go basis. Retirees with this coverage contribute 5%, 10%, and 10% of the monthly premium amount for the health (including prescription coverage), dental and vision coverage, respectively. The employer's payroll contribution rate to provide this benefit was 12.50% and 11.40% for fiscal years 2006 and 2005, respectively.

Notes to Basic Financial Statements (Continued)

Retirees are provided with life insurance coverage equal to 25% of the active life insurance coverage, $1,000 for spouse and $1,000 for each dependent under age 23. Premiums are fully paid by the State.

Early Out Retirement

In February 2002, former Governor John Engler proposed an early out retirement for qualified State employees. Approximately 2,850 State Employees retired by the end of the fiscal year 2002 and an additional 5,160 State employees retired in fiscal year 2003 under this program. Among those members who qualify are Tier 1 (defined benefit) participants and those former members who made an election under section 50 of Public Act 240 of 1943, as amended, to terminate membership in Tier 1 and transfer to become a qualified participant in Tier 2 (defined contribution). Upon their retirement, qualified Tier 2 participants shall receive a retirement allowance equal to the member's number of years of service and fraction of a year of credited service multiplied by .25% of his or her final compensation. For purposes of this section, such individuals shall be considered members of Tier 1 for the limited purpose of receiving a retirement allowance calculated under this section and paid by the System. This allowance will be paid from employer contributions to the System.

Banked Leave Time

Public Act 33 of 2004 amended the State Employees' Retirement Act to include Banked Leave Time (BLT) for members. BLT is an extension of the State's current annual leave program, which banks a predetermined number of hours per pay period. However, the BLT program will not have an effect on a member's Final Average Compensation calculation.

NOTE 2 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting and Presentation

The System's financial statements are prepared using the accrual basis of accounting. Contributions from the State are recognized as revenue when due and payable. Benefits and refunds are recognized when due and payable in accordance with the terms of the System.

Reserves

Public Act 240 of 1943, as amended, created the employees' savings reserve, pension reserve, employer's accumulation reserve, income account and expense account, and health insurance reserve. The financial transactions of the System are recorded in these accounts as required by Public Act 240 of 1943, as amended.

<u>Reserve for Employee Contributions</u> — Members no longer contribute to this reserve except to purchase eligible service credit or repay previously refunded contributions. This reserve represents active member contributions and interest less amounts transferred to the Pension Reserve for regular and disability retirement, amounts refunded to terminated members and unclaimed amounts transferred to the income account. At September 30, 2006, and 2005, the balance in this account was $210.0 million and $209.6 million, respectively.

<u>Reserve for Employer Contributions</u> — All employer contributions are credited to this reserve. Interest from the income account is credited annually. Amounts are transferred annually from this reserve to the Pension Reserve to fund that reserve. At September 30, 2006, and 2005, the balance in this account was $1.7 billion and $1.6 billion, respectively.

<u>Reserve for Retired Benefit Payments</u> — This represents the reserves for payment of future retirement benefits to current retirees. At retirement, a member's accumulated contributions plus interest are transferred into this reserve from the Employee Savings Reserve. Monthly benefits, which are paid to the retiree, reduce the reserve. At the end of each fiscal year, an amount determined by an annual actuarial valuation is transferred from the Employer's Accumulation Reserve to this reserve to bring the reserve into balance with the actuarial present value of retirement allowances. At September 30, 2006, and 2005, the balance in this account was $7.0 billion and $6.9 billion, respectively.

Notes to Basic Financial Statements (Continued)

Reserve for Undistributed Investment Income — The income account is credited with all investment earnings. Interest is transferred annually to the reserves. Administrative expenses are paid from the expense account. The legislature appropriates the funds necessary to defray and cover the administrative expenses of the System. At September 30, 2006, and 2005, the net balance of these accounts was $2.0 billion and $1.4 billion, respectively.

Reserve for Health Related Benefits — This reserve is credited with employee and employer contributions for retirees' health (including prescription coverage), dental, and vision benefits. Interest is allocated based on the beginning balance of the reserve. Premiums for health, dental, and vision benefits are paid from this fund. At September 30, 2006, and 2005, the unrestricted balance in this reserve was $18.8 million and $14.9 million, respectively.

Section 204 of Public Act 431 of 1984, as amended, provides management the ability to administer selected risk management related programs for insurance or related services. At September 30, 2006, and 2005, the Reserve for Health Related Benefits revenues exceeded expenses by $5.6 million and $12.2 million, respectively. If expenses had exceeded revenues, the State Sponsored Group Insurance Fund, which bears the risk of such losses, would have returned sufficient revenue to make the Reserve whole.

Health Advance Funding SubAccount — This funding subaccount was created by Public Act 93 of 2002 as a means to begin pre-funding, on an actuarial basis, health benefits for participants in the System. Any amounts received in the Health Advance Funding SubAccount (HAFS) and accumulated earnings on those amounts shall not be expended until the actuarial accrued liability for health benefits is at least 100% funded. However, the System may transfer an amount from the HAFS to the employer's accumulation fund (reserve for employer contributions) under certain conditions described in the enabling legislation. At September 30, 2006, and 2005, the balance of this subaccount was $41.3 million $33.9 million, respectively.

Reporting Entity

The System is a pension trust fund of the State. As such, the System is considered part of the State and is included in the State's Comprehensive Annual Financial Report as a pension trust fund. The System and its Board are not financially accountable for any other entities or other organizations. Accordingly, the System is the only entity included in this financial report.

Benefit Protection

Public Act 100 of 2002 was passed by the Michigan Legislature to protect pension benefits of public employees from alienation (being transferred). Alienation is attachment, garnishment, levy, execution, bankruptcy or other legal process except for divorce orders or eligible domestic relation orders. The statutes governing the System contained an "anti-alienation" clause to provide for this protection; however, many smaller public pension systems did not have the benefit of this protection. Therefore, Public Act 100 of 2002 was passed to establish legal protection of pension assets that encompasses all public employees.

Fair Value of Investments

Plan investments are reported at fair value. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. Corporate bonds not traded on a national or international exchange are based on equivalent values of comparable securities with similar yield and risk. Real estate debt is valued on the basis of future principal and interest payments, and is discounted at prevailing interest rates for similar instruments. The fair value of real estate investments is based on independent appraisals. Other investments not having an established market are recorded at estimated fair value.

Notes to Basic Financial Statements (Continued)

Investment Income

Dividend and interest income are recognized on the accrual basis. Fair value changes are recorded as investment income or loss. Purchases and sales of investments are recorded as of the trade date (the date upon which the transaction is initiated), except for purchase and sale of mortgages, real estate, and alternative investments, which are recorded as of the settlement date (the date upon which the transaction is ultimately completed). The effect of recording such transactions as of the settlement date does not materially affect the financial statements.

Cost of Administering the System

Each year a restricted general fund appropriation is requested to fund the on-going business operations of the System. These administrative costs are ultimately funded by the System through the regular transfer of funds from the System to the general fund based on either a direct cost or allocation basis depending on the nature of the expense. Costs of administering the System are financed by undistributed investment income of the System.

Property and Equipment

Office space is leased from the State on a year-to-year basis. Office equipment is capitalized if the value exceeds $5,000. These assets are recorded at cost and are reported net of depreciation in the Statement of Pension and Postemployment Healthcare Plan Net Assets. Such assets are depreciated on a straight-line basis over 10 years. As of September 30 1998, all capitalized equipment was fully depreciated. No additional equipment has been capitalized for the System since that date.

Related Party Transactions

Leases and Services — The System leases operating space and purchases certain administrative, data processing, legal and investment services from the State. The space and services are not otherwise available by competitive bid. The following summarizes costs incurred by the System for such services.

	2006	2005
Building Rentals	$ 108,835	$ 88,325
Technological Support	1,444,293	1,044,403
Attorney General	238,446	270,554
Investment Services	2,020,711	1,949,445
Personnel Services	1,566,340	1,490,449

Commitment and Contingency – The State has signed a contract with a vendor for technological support through 2006. As of September 30, 2006, the System's portion of this commitment is approximately $786,372.

Cash — On September 30, 2006, and 2005, the System had $10.7 million and $21.5 million, respectively in a common cash investment pool maintained for various State operating funds. The participating funds in the common cash pool earn interest at various rates depending upon prevailing short-term interest rates. Earnings from these activities amounted to $0.6 million and $0.5 million for the years ended September 30, 2006, and 2005, respectively.

Excess Benefits

Internal Revenue Service (IRS) Code Section 415 requires that, for individuals who receive retirement benefits in excess of established limits, these benefits be recorded and reported outside of the pension plan in order to keep the qualified status of the plan. This includes coordination of benefit issues whereby a retiree participates in more than one qualified plan. In fiscal years 2005 and 2006, the System provided excess benefits to one retiree.

Reclassification of Prior Year Amounts

Certain prior year amounts have been reclassified to conform with the current year presentation.

Notes to Basic Financial Statements (Continued)

NOTE 3 - CONTRIBUTIONS

Members currently participate in the System on a non-contributory basis. Under certain circumstances, members may contribute to the System for the purchase of creditable service such as military service or maternity leave. Effective August 1, 1998, the retirement act was amended to permit a “universal buy-in.” With a universal buy-in, a member may elect to purchase no more than 5 years of service credit (less other service credit purchased). The State is required by Public Act 240 of 1943, as amended, to contribute amounts necessary to finance the benefits of its employees. Contribution provisions are specified by State statute and may be amended only by action of the State Legislature.

Periodic employer contributions to the System are determined on an actuarial basis using the entry age normal actuarial cost method. Under this method, the actuarial present value of the projected benefits of each individual included in the actuarial valuation is allocated on a level basis over the service of the individual between entry age and assumed exit age. The portion of this cost allocated to the current valuation year is called the normal cost. The remainder is called the actuarial accrued liability. Normal cost is funded on a current basis. The unfunded (overfunded) actuarial accrued liability is amortized over a 30-year period for the 2006 fiscal year and a 31-year period for the 2005 fiscal year. Actual employer contributions for retirement benefits were $270.7 million and $256.4 million for fiscal years 2006 and 2005, respectively, representing 13.6% of annual covered payroll for the year ended September 30, 2005. The fiscal year 2006 annual covered payroll is not yet available. During fiscal year 2006 and 2005, no transfers were made from the Health Advance Funding SubAccount. This Act created the Defined Contribution Plan for State employees hired after March 31, 1997. Required employer contributions for pensions included:

1. $154.4 million and $152.1 million for fiscal years 2006 and 2005, respectively, for the normal cost of pensions representing 8.2% (before reconciliation) of annual covered payroll for fiscal year 2005.
2. $212.3 million and $156.1 million for fiscal years 2006 and 2005, respectively, for amortization of overfunded actuarial accrued liability representing 11.3% (before reconciliation) of annual covered payroll for fiscal year 2005.

The System is required to reconcile with actuarial requirements annually. Any funding excess or deficiency is smoothed over 5 years. One fifth (20%) of the funding excess or deficiency is included in the subsequent years' contribution, and is not recognized as a payable or receivable in the accounting records.

In March 2001, the Internal Revenue Service issued a private letter ruling allowing the System's members to purchase service credit and repay refunds using tax-deferred (pre-tax) dollars. The program was implemented and payments began in fiscal year 2002.

The program allows members to purchase service credit and repay refunds on a tax-deferred basis. Members sign an irrevocable agreement that identifies the contract duration, monthly payment, total contract amount and years of service credit being purchased. The duration of the contract can range from 1 to 20 years. The amounts are withheld from the members' paycheck and are treated as employer pick-up contributions pursuant to Internal Revenue Code Section 414(h). At September 30, 2006, and September 30, 2005 there were 6,959 and 7,302 agreements, respectively. Agreement amounts that will not be collected within 12 months are discounted using the assumed actuarial rate of return of 8%. The average length remaining of a contract was approximately 14 and 15 years for 2006 and 2005. The short-term receivable was $12.8 million and the discounted long-term receivable was $68.1 million at September 30, 2006. At September 30, 2005, the short-term receivable was $13.6 million and the discounted long-term receivable was $74.4 million.

Notes to Basic Financial Statements (Continued)

NOTE 4 – INVESTMENTS

Investment Authority

Under Public Act 380 of 1965, as amended, the authority for the purchase and the sale of investments resides with the State Treasurer. Investments are made subject to the Michigan Public Pension Investment Act, Public Act 314 of 1965, as amended. The Michigan Public Pension Investment Act authorizes, with certain restrictions, the investment of pension fund assets in stocks, corporate and government bonds and notes, mortgages, real estate, and certain short-term and alternative investments. Investments must be made for the exclusive purposes of providing benefits to active members, retired members and beneficiaries, and for defraying the expenses of investing the assets.

Under Public Act 314 of 1965, as amended, the State Treasurer may invest up to 5% of the System's assets in small businesses having more than one-half of its assets or employees in Michigan as described in section 20(a) of the Act and up to 20% of the System's assets in investments not otherwise qualified under the Act as described in section 20(d). Alternative investments include limited partnerships and distributions from these partnerships in the form of bonds, preferred stock, common stock, and direct investments.

Derivatives

The State Treasurer employs the use of derivatives in the investment of the pension trust funds.

Derivatives are used in managing pension trust fund portfolios, but uses do not include speculation or leverage of investments. Less than 12.0% of the total pension trust fund's portfolio has been invested from time to time in futures contracts, swap agreements and option contracts. State investment statutes limit total derivative exposure to 15.0% of a fund's total asset value, and restrict uses to replication of returns and hedging of assets. Swap agreements represent the largest category of derivatives used, and they represented 9.0% of market value of total pooled assets on September 30, 2006 and 10.3% of market value of total pooled assets on September 30, 2005. Option contracts represent the second largest category of derivatives used, and they represented 0.6% of market value of total pooled assets on September 30, 2006, and 0.0% of market value of total pooled assets on September 30, 2005. Futures contracts represent the third largest category of derivatives used, and they represented 0.0% of market value of total pooled assets on September 30, 2006, and 0.3% of market value of total pooled assets on September 30, 2005.

To enhance management flexibility, the State Treasurer has purchased futures contracts tied to S&P indices. The futures contracts are combined with short-term investments to replicate the return of the S&P indices. The value of these synthetic equity structures is a combination of the value of the futures contract and the value of the dedicated short-term investments.

To capitalize on shorter-term windows of investment opportunities, the State Treasurer has purchased option contracts. Options allow more flexibility in achieving investment goals without disturbing the return/risk profiles of the longer-term strategies of the underlying investments.

To diversify the pension trust fund's portfolio, the State Treasurer has entered into swap agreements with investment grade counterparties, which are tied to stock market indices in the United States and twenty-two foreign countries. The notional amounts of the swap agreements at September 30, 2006, and 2005, were $711.6 million and $784.5 million, respectively. Approximately one half of the notional amount tied to foreign stock market indices is hedged against foreign currency fluctuations. The swap agreements provide that the System will pay quarterly, over the term of the swap agreements, interest indexed to the three month London Inter Bank Offer Rate (LIBOR), adjusted for an interest rate spread, on the notional amount stated in the agreements. At the maturity of the swap agreements, the pension fund will either receive the increase in the value of the equity indices from the level at the inception of the agreements, or pay the decrease in the value of the indices. Swap agreement maturity dates range from October 2006 to July 2009. U.S. domestic LIBOR based floating rate notes and other investments earning short-term interest are held to correspond with the notional amount of the swap agreements. The State Treasurer maintains custody and control of these dedicated notes and short-term investments.

Notes to Basic Financial Statements (Continued)

The value of these synthetic equity structures is a combination of the value of the swap agreements and the value of the notes and short-term investments. The book value represents the cost of the notes and short-term investments. The current value represents the current value of the notes and short-term investments and the change in value of the underlying indices from the inception of the swap agreements. The current value is used as a representation of the fair value based on the intention to hold all swap agreements until maturity. For fiscal years ending September 30, 2006, and 2005, international equity investment programs involving swaps, received realized gains and earned interest income of $157.6 million and $67.3 million, respectively.

The unrealized gain of $267.4 million at September 30, 2006, and $248.5 million at September 30, 2005, primarily reflects the increases in international stock indices and changes in currency exchange rates. The combined swap structure generally realizes gains and losses on a rolling three-year basis.

The respective September 30, 2006, and 2005 swap values are as follows:

	Notional Value	Current Value
9/30/2006 (dollars in millions)	$ 711.6	$ 978.6
9/30/2005 (dollars in millions)	784.5	1,031.5

The amounts shown above reflect both the total International Equity Pool swap exposure, and the smaller swap exposure to the S&P Small Cap Index Pool.

Security Lending

State statutes allow the System to participate in securities lending transactions, and the System has, by way of Security Lending Authorization Agreement, authorized the agent bank to lend the System's securities to broker-dealers and banks pursuant to a form of loan agreement.

During the fiscal year, the agent bank lent, at the direction of the System, the System's securities and received cash (United States and foreign currency), securities issued or guaranteed by the United States government, sovereign debt rated A or better, convertible bonds and irrevocable bank letters of credit as collateral. The agent bank did not have the ability to pledge or sell collateral securities delivered absent a borrower default. Borrowers are required to deliver collateral for each loan equal to (i) in case of loaned securities denominated in United States dollars or whose primary trading market is located in the United States or sovereign debt issued by foreign governments, 102% of the market value of the loaned securities; and (ii) in the case of loaned securities not denominated in United States dollars or whose primary trading market is not located in the United States, 105% of the market value of the loaned securities.

The System did not impose any restrictions during the fiscal year on the amount of the loans that the agent bank made on its behalf and the agent bank indemnified the System by agreeing to purchase replacement securities, or return cash collateral in the event borrower failed to return the loaned security or pay distributions thereon. There were no such failures by any borrowers during the fiscal year. Moreover, there were no losses during the fiscal year resulting from a default of the borrowers or the agent bank.

During the fiscal year, the System and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested in a collateral account dedicated to the System. As of September 30, 2006, such account had an average weighted maturity to next reset of 22 days and an average weighted maturity of 678 days. Because the loans were terminable at will, their duration did not generally match the duration of the investments made with cash collateral. On September 30, 2006, the System had no credit risk exposure to borrowers. The cash held for securities on loan for the System as of September 30, 2006, were $1,699,064,634. The carrying amount, which is the fair market value, of securities on loan for the System as of September 30, 2006, was $1,655,552,810.

Gross income from security lending for the fiscal year was $39,745,998. Expenses associated with this income were the borrower's rebate of $37,896,886 and fees paid to the agent of $356,995.

Notes to Basic Financial Statements (Continued)

Risk

In accordance with GASB Statement No. 40, investments require certain disclosures regarding policies and practices, and the risks associated with them. The credit risk, (including custodial credit risk and concentration of credit risk), the interest rate risk, and the foreign currency risk are discussed in the following paragraphs. Amounts represent the pro rata share of the underlying investments as required by GASB 40. These are held in internal investment pools and reported as such in the financial statements.

Credit Risk - Credit risk is the risk that an issuer will not fulfill its obligations.

- Short-Term Fixed Income Investments - Prime commercial paper investments must be rated A-1 or P-1 at the time of purchase as rated by the two major rating services Standard and Poor's Corporation (S&P) and Moody's Investor Service (Moody's), respectively. Borrowers must have at least $400.0 million in commercial paper outstanding, and the State Treasurer may not invest in more than 10.0% of the borrowers outstanding debt. The investments are further limited to $200.0 million in any borrower, unless the borrower has a A-1+ rating, in which case the investment is not to exceed $300.0 million.

- Long-Term Fixed Income Investments – These investments must be investment grade or better at the time of purchase unless specific requirements are met, as defined by PA 314 of 1965 as amended and the State Treasurer's investment policy. Law defines investment grade as investments in the top four major grades, rated by two national rating services, S&P (AAA, AA, A, BBB) and Moody's (Aaa, Aa, A, Baa). At September 30, 2006, the System was in compliance with the policy in all material aspects.

Notes to Basic Financial Statements (Continued)

Rated Debt Investments
(in thousands)
As of September 30, 2006 and 2005

	2006				2005			
Investment Type	**Fair Value**	**S&P**	**Fair Value**	**Moody's**	**Fair Value**	**S&P**	**Fair Value**	**Moody's**
Short Term	$ 528,860	A-1	$ 623,405	P-1	$ 432,631	A-1	$ 473,955	P-1
	18,187	A-2	25,467	P-2	19,621	A-2	19,621	P-2
	138,138	NR	36,313	NR	95,392	NR	54,068	NR
U.S. Agency - Sponsored								
	589,588	AAA	589,588	Aaa	490,632	AAA	490,632	Aaa
	15,601	NR	15,601	NR				
Corporate Bonds & Notes								
	115,436	AAA	118,354	Aaa	132,422	AAA	132,422	Aaa
	161,719	AA	217,969	Aa	180,370	AA	214,461	Aa
	292,721	A	194,487	A	318,778	A	279,620	A
	71,962	BBB	92,724	Baa	74,526	BBB	93,899	Baa
	1,172	BB	4,327	Ba	60,020	BB	26,533	Ba
	666	B	0	B				
	16,285	NR	32,100	NR	12,139	NR	31,320	NR
International *								
	77,223	AAA	67,449	Aaa	163,613	AAA	163,613	Aaa
	172,046	AA	274,663	Aa	187,420	AA	320,606	Aa
	226,744	A	108,510	A	391,930	A	253,037	A
	0	BB	0	Ba	19,028	BB	19,028	Ba
	0		25,391	NR			5,707	NR
Equity*	10,389	AA	67,106	Aa	10,375	AA	20,749	Aa
	56,717	A	0		10,374	A	0	
Total	$ 2,493,454		$ 2,493,454		$ 2,599,271		$ 2,599,271	

NR - not rated   NR - not rated

* International and Equity Investment types consist of domestic floating rate note used as part of a Swap strategy

Notes to Basic Financial Statements (Continued)

Custodial Credit Risk – Custodial credit risk for investments is the risk that, in the event of a failure of the counterparty, the State will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party.

- Investment securities are exposed to custodial credit risk if the securities are uninsured, are not registered in the name of the government and are held by either:
- The counterparty or
- The counterparty's trust department or agent but not in the government name.

The State Treasurer does not have a policy for custodial risk. However, the State's custodial bank had a credit rating of AA at September 30, 2006. As of September 30, 2006, and 2005, the government securities with a market value of $4,804 thousand and $9,795 thousand, respectively, were exposed to custodial credit risk. These securities were held by the counterparty not in the name of the System.

Concentration of Credit Risk – Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issuer.

Other than obligations issued, assumed or guaranteed by the United States, its agencies or United States government sponsored enterprises, the System is prohibited by P.A. 314 of 1965, as amended, from investing in more than 5.0% of the outstanding obligations of any one issuer or investing more than 5.0% of a system's assets in the obligations of any one issuer.

At September 30, 2006, and 2005, there were no investments in any single issuer that accounted for more than 5.0% of the System's assets nor were there any investments totaling more than 5.0% of the obligations of any one issuer, other than U.S. Government Securities as described above.

Interest Rate Risk – Fixed Income Investments – Interest rate risk is the risk that changes in interest rates of debt investments will adversely affect the fair value of an investment.

The State Treasurer's policy states that cash equivalents are invested in short term fixed income securities with an average weighted maturity of less than one year to provide liquidity and safety of principal from capital market and default risk. At September 30, 2006, and 2005, the fair value of the System's prime commercial paper was $685,185 thousand and $547,645 thousand with the weighted average maturity of 41 days and 38 days, respectively.

The State Treasurer does not have a policy regarding interest rate risk for long term debt investments. However, the pension funds are invested with a long term strategy. The goal is to balance higher returns while accepting minimum risk for the return. Analyzing the yield curve on individual securities as compared to U.S. Treasuries determines, in part, what is an acceptable risk for the return. Therefore, market conditions such as lower interest rates result in shorter duration and higher interest rates result in longer duration.

Notes to Basic Financial Statements (Continued)

Debt Securities
(in thousands)
As of September 30, 2006 and 2005

	2006		2005	
	Fair Value	Effective Duration in Years	Fair Value	Effective Duration in Years
Government				
U. S. Treasury	$ 114,186	3.1	$ 78,199	4.3
U. S. Agencies - Backed	247,269	5.7	222,688	5.3
U. S. Agencies - Sponsored	605,189	3.7	490,632	2.5
Corporate	659,961	4.4	778,255	4.1
International*				
U. S. Treasury	19,505	0.5	9,506	0.1
U. S. Agencies - Sponsored	9,727	0.1		
Corporate	466,287	0.1	752,485	0.2
Equities*				
Corporate	67,106	0.6	20,749	0.2
Total	$ 2,189,230		$ 2,352,514	

*International and Equities contain U.S. Government and Corporate Debt Securities as a part of their derivative strategies. The interest rates reset on a quarterly basis for these securities.

Foreign Currency Risk – Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment or deposit.

The System invests in various securities denominated in foreign currencies. These investments are limited to 20% of the total assets of the System with an additional limit of 5% of the outstanding foreign securities of any single issuer. No investment is allowed in a country that has been identified by the United States State Department as engaging in or sponsoring terrorism. These limits are set forth in P.A. 314 of 1965, as amended. The types of foreign investments include equities, fixed income, mutual funds, real estate, and limited partnerships. At September 30, 2006, and 2005, the total amount of foreign investment subject to foreign currency risk were $629,553 thousand and $435,877 thousand which amounted to 5.8% and 4.3% of total investments (exclusive of cash collateral on loaned securities) of the System, respectively.

Notes to Basic Financial Statements (Continued)

Foreign Currency Risk
(in thousands)
As of September 30, 2006

Region	Country	Currency	Alt. Invest. Market Value In U.S. $	Equity Market Value In U.S. $	Real Estate Market Value In U.S. $	International Equities Market Value In U.S. $	International Derivatives Market Value In U.S. $*
AMERICA							
	Canada	Dollar		$ 3,939			
	Mexico	Peso		14,099			
EUROPE							
	European Union	Euro	$ 86,534	26,541		$ 6,287	$ 45,889
	Switzerland	Franc		8,392			10,071
	Sweden	Krona		1,814			2,117
	Denmark	Krone				111	1,567
	Norway	Krone		894		10	1,710
	U.K.	Sterling	4,597	11,878		474	25,068
PACIFIC							
	Australia	Dollar		3,166			6,231
	Hong Kong	Dollar		626			4,234
	Japan	Yen	1,554	16,065		62	23,144
	Singapore	Dollar					970
	South Korea	Won		1,931			7,919
VARIOUS				127,559	$ 43,469	140,631	
	Total		$ 92,685	$ 216,904	$ 43,469	$ 147,575	$ 128,920

*Note: International derivatives market value exposure to foreign currency risk is the net amount of unrealized gains and unrealized losses. Maturity dates on these investments range from October 2006 through November 2008 with an average maturity of 1.1 years.

Notes to Basic Financial Statements (Continued)

Foreign Currency Risk
(in thousands)
As of September 30, 2005

Region	Country	Currency	Alt. Invest. Market Value in U.S. $	Equity Market Value In U.S. $	International Equities Market Value In U.S. $	International Derivatives Market Value In U.S. $*
AMERICA						
	Mexico	Peso		$ 51,339		
EUROPE						
	European Union	Euro	$ 64,603		$ 12,927	$ 32,107
	Switzerland	Franc		6,418		4,912
	Sweden	Krona			83	2,850
	Denmark	Krone			302	1,769
	Norway	Krone			338	1,705
	U.K.	Sterling	5,686	34,484	7,920	17,905
PACIFIC						
	Australia	Dollar			84	8,004
	Hong Kong	Dollar			1,159	2,148
	Japan	Yen	1,648		854	24,401
	New Zealand	Dollar				353
	Singapore	Dollar				1,200
	South Korea	Won				4,696
VARIOUS					145,982	
	Total		$ 71,937	$ 92,241	$ 169,649	$ 102,050

*Note: International derivatives market value exposure to foreign currency risk is the net amount of unrealized gains and unrealized losses. Maturity dates on these investments range from October 2005 through September 2008 with an average maturity of 1.5 years.

Notes to Basic Financial Statements (Continued)

NOTE 5 - ACCOUNTING CHANGES

In fiscal year 2005, the State implemented Governmental Accounting Standards Board (GASB) Statement No. 40, *Deposit and Investment Risk Disclosures* (an amendment of GASB No. 3), which modifies and expands disclosure requirements for deposits and investments. The new requirements are effective for fiscal periods beginning after June 15, 2004. Information within this financial report is presented on a comparative basis.

The GASB has issued Statement No. 44, *Economic Condition Reporting: the Statistical Section*, which provides guidance on the tables and narrative explanations in the statistical section. The requirements of this statement are effective for fiscal periods beginning after June 15, 2005. This statement was adopted in fiscal year 2005 and is reflected in this report.

The GASB has issued Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, which establishes uniform standards of financial reporting by state and local governmental entities for other post-employment benefit plans (OPEB plans). The requirements of this statement are effective one year prior to the effective date of the related Statement (GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions)* for the employer or the largest employer in the plan. Because the State of Michigan is a phase 1 government (those with total annual revenues of $100 million or more), the System is required to implement Statement No. 43 in financial statements for periods beginning after December 15, 2005.

The GASB has issued Statement No. 47, *Accounting for Termination Benefits*, which provides guidance on how employers should account for benefits associated with either voluntary or involuntary termination. The requirements of the new statement become effective for fiscal periods beginning after June 15, 2005 (except for those provisions involving other postemployment benefits, which only take effect upon the implementation of GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*). It has been determined, upon review of GASB Statement No. 47, that the Statement has no effect on reporting for the System.

NOTE 6 - COMMITMENTS AND CONTINGENCIES

Under the Administrative Procedures Act, members may appeal a decision made by the Board. Once the administrative procedure has been exhausted, the decision may be appealed in Michigan's court system. Various cases that have exhausted the administrative procedures have been appealed in the court system. These cases are in the normal course of business and the System does not anticipate any material loss as a result of the contingent liabilities.

Required Supplementary Information

Schedule of Funding Progress

Expressing the net assets available for benefits as a percentage of the actuarial accrued liability provides one indication of the System's funding status. Analysis of this percentage over time indicates whether the System is becoming financially stronger or weaker. Generally, the greater this percentage, the stronger the System. Trends in unfunded actuarial accrued liability and annual covered payroll are both affected by inflation. Expressing the unfunded or overfunded actuarial accrued liability as a percentage of annual covered payroll approximately adjusts for the effects of inflation and aids analysis of progress made in accumulating sufficient assets to pay benefits when due. Generally, the smaller this percentage, the stronger the System.

Retirement Benefits ($ in millions)

Valuation Date Sept 30	Actuarial Value of Assets (a)	Actuarial Accrued Liability[1] (AAL) Entry Age (b)	Unfunded (Overfunded) Accrued Liability (UAAL) (b-a)	Funded Ratio AAL (a/b)	Covered Payroll (c)	UAAL as a % of Covered Payroll ((b-a)/c)
1996	$ 6,678	$ 7,147	$ 469	93.4 %	$ 2,515	18.7 %
1997	7,516	8,213	697	91.5	2,273	30.7
1997 [2]	8,834	8,101	(733)	109.0	2,273	(32.2)
1998	9,109	8,374	(735)	108.8	2,108	(34.9)
1998 [2]	9,109	8,497	(612)	107.2	2,108	(29.0)
1999	9,648	9,029	(619)	106.9	2,214	(28.0)
2000	10,337	9,474	(863)	109.1	2,254	(38.3)
2001	10,633	9,878	(755)	107.6	2,231	(33.8)
2002	10,616	10,753	137	98.7	2,133	6.4
2003	10,441	11,761	1,320	88.8	1,860	71.0
2004 [3]	10,149	12,004	1,855	84.5	1,889	98.2
2005	9,897	12,400	2,503	79.8	1,880	133.1

(1) Based on entry age normal actuarial method.

(2) Revised actuarial assumptions and revised asset valuation method.

(3) Revised actuarial assumptions.

Required Supplementary Information (Continued)

Schedule of Employer Contributions

Fiscal Year Ended Sept. 30	Annual Required Contribution (ARC)	Actual Contribution	Percentage Contributed
1997	$ 244,102,003	$ 288,366,799	118.1 %
1998	126,396,181	145,734,677	115.3
1999	111,415,984	121,119,857	108.7
2000	120,906,261	121,817,366	100.8
2001	102,989,963	112,299,808	109.0
2002	111,551,549	87,486,128 [1]	78.4
2003	184,214,419	79,291,845	43.0 [2]
2004	262,546,900	103,873,294 [3]	39.6
2005	308,208,544	256,433,052	83.2
2006	366,650,515	270,705,017	73.8

[1] Employer contributions for fiscal year 2002 were transferred at year-end into the Health Advance Funding SubAccount established under Public Act 93 of 2002. PA 93 states in part that, "For each fiscal year that begins on or after October 1, 2001, if the actuarial valuation prepared … demonstrates that as of the beginning of the fiscal year, and after all credits and transfers required by this act for the previous fiscal year have been made … the annual level percent of payroll contribution rate … may be deposited into the Health Advance Funding SubAccount…" Pursuant to this legislation, a transfer was made into the subaccount in the amount of $87.5 million. The transfer would effectively bring the contribution percentage to 0.0% for the fiscal year ended September 30, 2002.

[2] The ARC and percentage contributed are due to the $87.5 million transfer in fiscal year 2002 and an additional transfer of $17.4 million into the Health Advance Funding SubAccount in fiscal year 2003.

[3] In fiscal year 2004, $24.4 million was transferred from the Health Advance Funding SubAccount to the Pension Plan at the request of the State Budget Director and with the approval of the legislature. The purpose of this transfer was to reduce the contribution rates charged to State agencies for fiscal year 2003-2004 to help bring the general fund budget back into balance.

Notes to Required Supplementary Information

NOTE A - DESCRIPTION

Ten year historical trend information designed to provide information about the System's progress made in accumulating sufficient assets to pay benefits when due is presented in the preceding schedules. Other ten year historical trend information related to the System is presented in the Statistical and Actuarial Sections of the report. This information is presented to enable the reader to assess the progress made by the System in accumulating sufficient assets to pay pension benefits as they become due.

The comparability of trend information is affected by changes in actuarial assumptions, benefit provisions, actuarial funding methods, accounting policies, and other changes. Those changes usually affect trends in contribution requirements and in ratios that use the pension benefit obligation as a factor.

The Schedule of Funding Progress and Schedule of Employer Contributions are reported as historical trend information. The Schedule of Funding Progress is presented to measure the progress being made to accumulate sufficient assets to pay benefits when due. The Schedule of Employer Contributions is presented to show the responsibility of the Employer in meeting the actuarial requirements to maintain the System on a sound financial basis.

NOTE B - SUMMARY OF ACTUARIAL ASSUMPTIONS

The information presented in the required supplementary schedules was determined as part of the actuarial valuations at the dates indicated. Additional information as of the latest actuarial valuation follows:

Valuation Date	9/30/2005
Actuarial Cost Method	Entry Age, Normal
Amortization Method	Level Dollar, Closed
Remaining Amortization Period	31 years*
Asset Valuation Method	5-Year Smoothed Market
Actuarial Assumptions:	
Wage Inflation Rate	3.5%
Investment Rate of Return	8.0%
Projected Salary Increases	3.5-14.4%
Cost-of-Living Adjustments	3% Annual Non-Compounded with Maximum Annual Increase of $300 for those eligible

*When the actuarial accrued liability for a defined benefit pension plan is underfunded or overfunded, the difference should be amortized over a period not to exceed forty years for the fiscal periods beginning prior to June 15, 2006. After that date, the amortization period may not exceed thirty years.

Supporting Schedules

Comparative Summary of
Pension Plan Administrative Expenses
As of September 30, 2006 and 2005

	2006	2005
Personnel Services:		
Staff Salaries	$ 1,072,078	$ 1,036,638
Retirement and Social Security	293,581	275,384
Other Fringe Benefits	200,681	178,427
Total	1,566,340	1,490,449
Professional Services:		
Accounting	225,506	238,421
Actuarial	94,887	97,000
Attorney General	238,446	270,554
Audit	36,651	20,480
Consulting	78,045	69,585
Medical	276,303	263,243
Total	949,838	959,283
Building and Equipment:		
Building Rentals	108,835	88,325
Equipment Purchase, Maintenance, and Rentals	9,449	12,445
Total	118,284	100,770
Miscellaneous:		
Travel and Board Meetings	5,175	2,658
Office Supplies	13,330	13,714
Postage, Telephone, and Other	453,003	607,128
Printing	77,780	79,580
Technological Support	1,444,293	1,044,403
Total	1,993,581	1,747,483
Total Administrative Expenses	$ 4,628,043	$ 4,297,985

Supporting Schedules (Continued)

Schedule of Investment Expenses

	2006	2005
Real Estate Operating Expenses	$ 94,039	$ 152,515
Securities Lending Expenses	38,253,881	13,710,240
Other Investment Expenses*		
ORS-Investment Expense	2,020,711	1,949,445
Custody Fees	228,770	286,192
Management Fees-Real Estate	601,122	164,425
Management Fees-Alternative	10,408,922	10,557,231
Research Fees	189,701	207,738
Total Investment Expenses	$51,797,146	$ 27,027,786

* See Investment Section for fees paid to investment professionals

Schedule of Payments to Consultants

	2006	2005
Independent Auditors	$ 36,651	$ 20,480
Consulting	78,045	69,585
Medical	276,303	263,243
Attorney General	238,446	270,554
Accounting	225,506	238,421
Actuary	94,887	97,000
Total Payment to Consultants	$ 949,838	$ 959,283

Supporting Schedules (Continued)

Detail of Changes in Plan Net Assets (Pension and Postemployment Healthcare Benefits)
For the Year Ended September 30, 2006

	Employee Contributions	Employer Contributions	Retired Benefit Payments	Undistributed Investment Income	Health Related Benefits*	Total
Additions:						
Contributions:						
Member contributions	$ 9,434,310				$ 11,528,041	$ 20,962,351
Employer contributions		$ 270,705,017			356,674,243	627,379,260
Total Contributions	9,434,310	270,705,017	-	-	368,202,284	648,341,611
Investment income (loss):						
Investment income (loss)				$ 1,260,667,439		1,260,667,439
Interest income					5,660,782	5,660,782
Investment expenses:						
Real estate operating expenses				(94,039)		(94,039)
Other investment expenses				(13,449,226)		(13,449,226)
Securities lending activities:						
Securities lending income				39,745,998		39,745,998
Securities lending expenses				(38,253,881)		(38,253,881)
Net investment income (loss)	-	-	-	1,248,616,291	5,660,782	1,254,277,073
Transfer from other systems	123,059					123,059
Miscellaneous income				106,169		106,169
Total additions	9,557,369	270,705,017	-	1,248,722,460	373,863,066	1,902,847,912
Deductions:						
Benefits paid to plan members and beneficiaries:						
Retirement benefits			$ 767,000,706			767,000,706
Health benefits					328,528,595	328,528,595
Dental/vision benefits					34,069,090	34,069,090
Refunds of member contributions	145,554	105,809	2,523			253,886
Transfers to other systems	2,647					2,647
Administrative expenses				4,628,043		4,628,043
Total deductions	148,201	105,809	767,003,229	4,628,043	362,597,685	1,134,482,967
Net Increase (Decrease)	9,409,168	270,599,208	(767,003,229)	1,244,094,417	11,265,381	768,364,945
Other Changes in Net Assets:						
Interest allocation	2,966,829	550,252,642	129,324,726	(682,544,197)		-
Transfers upon retirement	(12,001,854)		12,001,854			-
Transfers of employer shares		(729,094,655)	729,094,655			-
Total other changes in net assets	(9,035,025)	(178,842,013)	870,421,235	(682,544,197)	-	-
Net Increase (Decrease) After Other Changes	374,143	91,757,195	103,418,006	561,550,220	11,265,381	768,364,945
Net Assets (Liabilities) Held in Trust for Pension and Health Benefits:						
Beginning of Year	209,619,237	1,616,559,079	6,878,158,030	1,428,489,317	48,789,548	10,181,615,211
End of Year	$ 209,993,380	$ 1,708,316,274	$ 6,981,576,036	$ 1,990,039,537	$ 60,054,929	$ 10,949,980,156

*Includes Health Advance Funding SubAccount

Supporting Schedules (Continued)

Detail of Changes in Plan Net Assets (Pension and Postemployment Healthcare Benefits)
For the Year Ended September 30, 2005

	Employee Contributions	Employer Contributions	Retired Benefit Payments	Undistributed Investment Income	Health Related Benefits*	Total
Additions:						
Contributions:						
Member contributions	$ 30,395,040				$ 10,701,614	$ 41,096,654
Employer contributions		$ 256,433,052			324,305,023	580,738,075
Total Contributions	30,395,040	256,433,052	-	-	335,006,637	621,834,729
Investment income (loss):						
Investment income (loss)				$ 1,181,213,139		1,181,213,139
Interest income					2,712,374	2,712,374
Investment expenses:						
Real estate operating expenses				(152,515)		(152,515)
Other investment expenses				(13,165,031)		(13,165,031)
Securities lending activities:						
Securities lending income				14,504,416		14,504,416
Securities lending expenses				(13,710,240)		(13,710,240)
Net investment income (loss)	-	-	-	1,168,689,769	2,712,374	1,171,402,143
Transfer from other systems	119,594					119,594
Miscellaneous income				2,575		2,575
Total additions	30,514,634	256,433,052	-	1,168,692,344	337,719,011	1,793,359,041
Deductions:						
Benefits paid to plan members and beneficiaries:						
Retirement benefits			$ 746,673,263			746,673,263
Health benefits					295,431,830	295,431,830
Dental/vision benefits					27,402,308	27,402,308
Refunds of member contributions	63,782	227,810				291,592
Transfers to other systems	15,051					15,051
Administrative expenses				4,297,985		4,297,985
Total deductions	78,833	227,810	746,673,263	4,297,985	322,834,138	1,074,112,029
Net Increase (Decrease)	30,435,801	256,205,242	(746,673,263)	1,164,394,359	14,884,873	719,247,012
Other Changes in Net Assets:						
Interest allocation	2,202,532	552,270,949	112,647,000	(667,120,481)		-
Transfers upon retirement	(8,792,826)		8,792,826			-
Transfers of employer shares		(600,004,606)	600,004,606			-
Total other changes in net assets	(6,590,294)	(47,733,657)	721,444,432	(667,120,481)	-	-
Net Increase (Decrease) After Other Changes	23,845,507	208,471,585	(25,228,831)	497,273,878	14,884,873	719,247,012
Net Assets (Liabilities) Held in Trust for Pension and Health Benefits:						
Beginning of Year	185,773,730	1,408,087,494	6,903,386,861	931,215,439	33,904,675	9,462,368,199
End of Year	$ 209,619,237	$ 1,616,559,079	$ 6,878,158,030	$ 1,428,489,317	$ 48,789,548	$ 10,181,615,211

*Includes Health Advance Funding SubAccount

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INVESTMENT SECTION

Prepared by Michigan Department of Treasury, Bureau of Investments
Jaqueline M. Johnson, CFA, Director

INVESTMENT SECTION

Report on Investment Activity

INTRODUCTION

The State Treasurer reports the investment activity quarterly to the Investment Advisory Committee (Committee), which reviews the investments, goals, and objectives of the retirement funds and may submit recommendations regarding them to the State Treasurer. The Investment Advisory Committee may also, by a majority vote, direct the State Treasurer to dispose of any holdings that, in the Committee's judgment, are not suitable for the funds involved, and may, by unanimous vote, direct the State Treasurer to make specific investments.

The Investment Advisory Committee was created by Act 380 of the Public Acts of 1965. The three public members of the five-member committee are appointed by the Governor with the advice and consent of the Senate for three-year terms. The Director of the Department of Labor and Economic Growth and the Director of the Department of Management and Budget are ex-officio members. In fiscal 2006, members of the Committee were as follows: David G. Sowerby, CFA (public member), Robert E. Swaney, CFA (public member), Marina v.N. Whitman (public member), Robert W. Swanson (ex-officio member), and Lisa Webb Sharpe (ex-officio member). The public members serve without pay, but may be paid actual and necessary travel and other expenses.

INVESTMENT POLICY & GOALS

Investment policy states that the fiduciary will operate within standard investment practices of the prudent person and in accordance with Public Employee Retirement System Investment Act 314 of 1965. The fiduciary is authorized to invest in government obligations, corporate debt obligations, various short-term debt obligations, corporate (domestic and international) stocks, venture capital interests, mutual funds, real estate interests, and other investments subject to specific parameters. Above all, pension fund assets are to be invested for the exclusive benefit of the members of the System.

The System's Proxy Voting Policy sets forth directives on the following issues: Boards of Directors, corporate governance, social issues, corporate restructurings and defenses. All proxies are reviewed and voted in accordance with the System's policy.

The primary function of the System is to provide retirement, survivor and disability benefits to its members. The State Treasurer is the sole investment fiduciary and custodian of the System's investments pursuant to State law. The primary investment objective is to maximize the rate of return on the total investment portfolio, consistent with a high degree of prudence and sufficient diversity to eliminate inordinate risks and to meet the actuarial assumption for the investment rate of return, at a reasonable cost achieved by cultivating a motivated team of dedicated professionals. The goals of the System are:

1. Achieve the optimal rate of return possible within prudent levels of risk.
2. Maintain sufficient liquidity to pay benefits.
3. Diversify assets to preserve capital and avoid large losses.
4. Meet or exceed the actuarial assumption over the long term.
5. Perform in the top half of the public plan universe over the long term.
6. Exceed individual asset class benchmarks over the long term.
7. Operate in a cost-effective manner.

The strategy for achieving these goals is carried out by investing the assets of the System according to a five-year asset allocation model. The System currently has seven different asset classes, which provides for a well-diversified portfolio.

Report on Investment Activity (Continued)

Asset Allocation
(Excludes Collateral on Loaned Securities)

Investment Category	As of 9/30/06 Actual %		Five-Year Target %
Domestic Equity - Active	29.1%		26.0%
Large Cap Value Pool		12.9%	
Large Cap Growth Pool		13.1%	
Mid Cap Pool		2.1%	
Small Cap Pool		1.0%	
Domestic Equity - Passive	19.4%		19.0%
S&P 500 Index Pool		16.5%	
S&P MidCap Index Pool		2.1%	
Tactical Asset Allocation Pool		0.6%	
S&P Small Cap Index Pool		0.2%	
International Equity	12.3%		10.0%
International Equity Pool - Passive		10.5%	
International Equity Pool - Active		1.8%	
Alternative Investments Pool	12.0%		11.5%
Real Estate Pool	8.7%		10.5%
Fixed Income	16.3%		16.0%
Government Bond Pool		8.4%	
Corporate Bond Pools		6.0%	
Fixed Income Bond Pools		1.9%	
Short Term Investment Pool	2.2%		3.0%
Commodities	0.0%		4.0%
TOTAL	**100.0%**		**100.0%**

INVESTMENT AUTHORITY

Pursuant to State Law (Section 91 of Act No. 380 of the Public Acts of 1965, as amended), the State Treasurer, State of Michigan, is the investment fiduciary for the following four State sponsored retirement systems: Michigan Public School Employees' Retirement System, Michigan State Employees' Retirement System, Michigan State Police Retirement System, and Michigan Judges' Retirement System.

Act No. 314 of the Public Acts of 1965, as amended, authorizes the investment of assets of public employee retirement systems or plans created and established by the State or any political subdivision.

INVESTMENT RESULTS

Total Portfolio Results

For the fiscal year ended September 30, 2006, the total System's rate of return was 12.8% as compiled by State Street Analytics. Annualized rates of return for the three-year period ending September 30, 2006, were 12.7%; for the five-year period were 8.0%; and for the ten-year period were 8.8%.

Returns were calculated using a time-weighted rate of return in accordance with industry standards, unless a modification is described in the discussion of the reported return.

Report on Investment Activity (Continued)

Investment results were once again driven by double-digit returns from every major asset class except fixed income and short-term investments. Equity performance was strong much of the year in spite of soaring commodity and energy prices. Reversing a multi-year trend, the stocks of larger companies (S&P 500) outperformed those of mid-cap (S&P 400) and small cap (S&P 600), while non-U.S. markets performed better than U.S. indices. Residential housing experienced a meaningful slowdown during the year due to higher interest rates and stricter lending regulations. Alternative Investments continued to reap the benefits of a number of investments made in prior years as well as favorable markets for monetization of gains. Robust commercial real estate markets allowed the Real Estate pool to experience gains from both sales and appraisals of property. Bond markets struggled with the fear of higher inflation and a Federal Reserve intent on controlling inflation with higher short-term rates. Returns for the short-term pool climbed throughout the year to more than 4.5%.

For the fiscal year, the Dow Jones Industrial Average provided a total return of 13.3%, while the broader S&P 500 returned 10.8%. The Lehman Brothers U.S. Government/Credit Bond Index appreciated 3.3%.

The U.S. economy grew at a rate of 3.1% in fiscal year 2006 as measured by real gross domestic product. The December quarter was negatively affected by the impact of last year's hurricane season, but growth came roaring back in the March quarter. The second half of the year settled back to more normal, sustainable growth levels. Corporate earnings remained strong, led by robust profits from energy companies. Strong demand sent commodity and energy prices climbing during most of the year, with oil coming close to $80 per barrel in August before selling off sharply to nearly $60 by the end of the year. Inflation, as measured by the consumer price index, increased 3.7%.

Federal Reserve Chairman Alan Greenspan retired after nineteen years at the helm and Ben Bernanke was appointed his successor on February 1, 2006. The Federal Reserve continued to raise short-term rates by 25 basis points at each of its first six meetings in the fiscal year, but left rates unchanged at 5.25% in both August and September after seventeen consecutive rate hikes.

The System remains well diversified, both across and within asset classes, and positioned to benefit from moderate economic growth.

Large Cap Value Pool

The primary objective of the pool of large company value stocks is to generate a rate of return from investment in common stocks and equity equivalents that exceeds that of the S&P Citigroup Value Index.

The pool invests primarily in equities and equity-related securities of U.S. companies with market capitalization generally greater than $5 billion that are significantly under-priced as measured by price-to-earnings and/or price-to-book value ratios and below fair value as determined by quantitative and qualitative models. The focus is on companies with a strong presence in depressed categories, experienced management and conservative accounting practices. At times a portion of the pool may be invested in fixed-income short-term securities with maturities of less than one year.

The pool invests in equities and equity related securities that are listed on U.S. national securities exchanges, including American Depository Receipts (ADRs). It may also invest in stocks that are traded over-the-counter. The pool diversifies its investments by allocating its equities with weightings that approximate the weightings of the S&P Citigroup Value Index.

Report on Investment Activity (Continued)

The following summarizes the sector weightings of the pool as of September 30, 2006:

Financials	38.1 %
Industrials	13.7
Technology	10.0
Consumer Discretionary	8.6
Energy	8.5
Utilities	8.3
Materials	4.3
Other	3.5
Healthcare	2.7
Consumer Staples	2.3
Total	**100.0** %

The System's Large Cap Value pool achieved a total rate of return of 15.8% for fiscal 2006. This compared with 14.0% for the S&P 500 Citigroup Value Index.

At the close of fiscal year 2006, the Large Cap Value pool represented 12.9% of total investments. This compares to 15.5% for fiscal year 2005. The following summarizes the System's 19.2% ownership share of the Large Cap Value pool at September 30, 2006:

Large Cap Value Pool
(in thousands)

Short Term Pooled Investments	$ 47,020
Equities	1,348,022
Settlement Principal Payable	(1,296)
Settlement Proceeds Receivable	786
Accrued dividends	1,630
Total	**$ 1,396,162**

Large Cap Growth Pool

The primary investment objective is to generate a rate of return from investment in common stocks and equity equivalents that exceeds that of the S&P Citigroup Growth Index.

The pool invests primarily in equities and equity-related securities of U.S. companies with market capitalization generally greater than $5 billion whose earnings growth rates are expected to exceed the growth rate of the S & P 500 Index and are priced at or below fair value as determined by quantitative and qualitative models. The focus is on companies with a strong presence in categories anticipated to be fast growing, with high rates of unit sales growth and seasoned management. At times a portion of the pool may be invested in fixed-income short-term securities with maturities of less than one year.

The pool invests in equities and equity related securities that are listed on U.S. national securities exchanges, including American Depository Receipts (ADRs). It may also invest in stocks that are traded over-the-counter. The pool diversifies its investments by allocating its equities with weightings that approximate the weightings of the S&P Citigroup Growth Index.

Report on Investment Activity (Continued)

The following summarizes the sector weightings of various sectors in the pool as of September 30, 2006:

Technology	22.4 %
Health Care	20.3
Consumer Discretionary	12.5
Consumer Staples	12.1
Financials	11.1
Energy	10.7
Industrials	8.7
Other	1.0
Utilities	0.7
Materials	0.5
Total	**100.0** %

The Large Cap Growth pool's total rate of return was 7.2% for the fiscal year versus 7.4% for the S&P 500 Citigroup Growth Index.

At the close of fiscal year 2006, the Large Cap Growth pool represented 13.1% of total investments. This compares to 15.9% for fiscal year 2005. The following summarizes the System's 19.6% ownership share of the Large Cap Growth pool at September 30, 2006:

Large Cap Growth Pool
(in thousands)

Short Term Pooled Investments	$ 13,727
Equities	1,405,797
Settlement Principal Payable	(1,633)
Accrued dividends	1,046
Total	**$ 1,418,937**

Mid Cap Pool

Five Mid Cap managers were selected in fiscal year 2005, and added to the four managers selected in May 2005. The new managers began managing assets for the system in December 2005 and they were funded out of the Large Cap Value and Growth pools. The investment objective of the Mid Cap manager pool is to generate a rate of return from investment in common stocks and equivalents that exceeds that of the S&P 400 MidCap Index.

The Mid Cap pool return for the fiscal year was 7.1% versus the benchmark's 6.6%.

At the close of fiscal year 2006, the Mid Cap pool represented 2.1% of total investments. This compares to 0.9% for fiscal year 2005. The following summarizes the System's ownership share and composition of the Mid Cap pool at September 30, 2006:

Report on Investment Activity (Continued)

Mid Cap Value and Core Pools
(in thousands)

	Artisan Midcap Value	Cramer Rosenthal McGlynn Midcap Value	Los Angeles Capital Midcap Core	Wellington Management Midcap Core
Total Investment	$38,650	$36,026	$23,409	$34,904
Ownership Percentage	19.9%	20.0%	19.9%	19.9%

Mid Cap Growth Pools
(in thousands)

	Alliance Midcap Growth	Putnam Midcap Growth	Rainer Midcap Growth	UBS Midcap Growth	Wellington Midcap Growth
Total Investment	$24,218	$9,952	$21,139	$20,836	$21,649
Ownership Percentage	20.0%	20.1%	20.1%	20.1%	20.1%

Small Cap Pool

The primary investment objective is to generate a rate of return from investment in common stocks and equivalents that exceeds the S&P 600 Small Cap Index.

The System's Small Cap pool is invested with two Growth managers and three Value managers.

The Small Cap pool return for the fiscal year was 8.1% versus the benchmark's 7.2%.

At the close of fiscal year 2006, the Small Cap pool represented 1.0% of total investments. This compares to 0.8% for fiscal year 2005. The following summarizes the System's ownership share and composition of the Small Cap Pool at September 30, 2006:

Small Cap Pool
(in thousands)

	Delaware Growth	Putnam Growth	Putnam Value	Northpointe Value	Fisher Value
Total Investment	$32,932	$20,098	$17,141	$15,205	$18,546
Ownership Percentage	20.9%	20.8%	19.9%	19.8%	17.8%

S&P 500 Index Pool

The objective of the enhanced S&P 500 Index pool is to closely match the return performance of its benchmark, the S&P 500 Index, and to use low risk strategies to offset transaction costs and add to performance when possible. The pool generally holds all 500 stocks that make up the Standard & Poor's 500 Index in proportion to their weighting in the index. The following summarizes the sector weightings of the pool as of September 30, 2006:

Report on Investment Activity (Continued)

Financials	22.3 %
Information Technology	15.3
Health Care	12.7
Industrials	10.9
Consumer Discretionary	10.1
Consumer Staples	9.6
Energy	9.3
Telecomm. Services	3.5
Utilities	3.4
Materials	2.9
Total	**100.0** %

The S&P 500 Index pool return for the fiscal year was 10.8% versus the benchmark's 10.8%.

At the close of fiscal year 2006, the S&P 500 Index pool represented 16.5% of total investments. This compares to 13.4% for fiscal year 2005. The following summarizes the System's 19.6% ownership share of the S&P 500 Index pool at September 30, 2006:

S&P 500 Index Pool
(in thousands)

Short Term Pooled Investments	$	7,781
Equities		1,784,973
Futures Contracts		(3)
Settlement Proceeds Receivable		127
Settlement Principal Payable		(427)
Accrued dividends		1,940
Total	**$**	**1,794,391**

S&P MidCap Pool

The objective of the S&P MidCap Index pool is to closely match the return performance of its benchmark, the S&P MidCap, and use low risk strategies to offset transaction costs and add to performance when possible. The pool invests in equities of mid-size firms.

The S&P MidCap Index pool return for the fiscal year was 6.9% versus its benchmark’s 6.6%.

At the close of fiscal year 2006, the S&P MidCap Index pool represented 2.1% of total investments. This compares to 2.1% for fiscal year 2005. The following summarizes the System's 21.2% ownership share of the S&P MidCap Index pool at September 30, 2006:

S&P MidCap Pool
(in thousands)

Short Term Pooled Investments	$	1,869
Equities		223,480
Futures Contracts		(9)
Settlement Proceeds Receivable		423
Settlement Principal Payable		(670)
Accrued dividends		174
Total	**$**	**225,267**

Report on Investment Activity (Continued)

S&P Small Cap Index Pool

The objective of the S&P Small Cap Index pool is to match the return of its benchmark, the S&P 600 Small Cap Index. The S&P Small Cap Index pool return for the fiscal year was 7.5% versus the benchmark's 7.2%.

The pool achieves exposure to small cap equity returns primarily by investing in a combination of fixed income notes and equity swap agreements tied to the S&P 600 index. The total notional amount of the S&P 600 swap agreements is invested in dedicated fixed income notes. Interest from the dedicated notes is exchanged for S&P 600 stock returns. Use of swap agreements for a core position began in 2002, and an S&P 600 Exchange Traded Fund was added to this pool in 2004 to enhance management flexibility.

At the close of fiscal year 2006, the S&P Small Cap Index pool represented 0.2% of total investments. This compares to 0.3% for fiscal year 2005. The following summarizes the System's 20.8% ownership share of the S&P Small Cap Index pool at September 30, 2006:

S&P Small Cap Index Pool
(in thousands)

Short Term Pooled Investments	$	169
Equities		5,142
Fixed Income Securities		10,388
Market Value of Equity Contracts		2,092
Accrued dividends and interest		37
Total	**$**	**17,828**

International Equities Pool - Passive

The objective of the International Equity Pool - Passive is to match the return performance of the S&P/Citigroup Broad Market Index (BMI) Europe and Pacific Composite (EPAC) adjusted for net dividends. Fifty percent of the benchmark is hedged to the U.S. Dollar and the other half is impacted by foreign currency exchange rate changes. The total passive international return for the fiscal year was 17.5% compared to the Citigroup BMI-EPAC return of 18.5%.

Core passive exposure to international equity returns is achieved primarily by investing in a combination of fixed income LIBOR notes, short-term fixed income investments, and equity swap agreements on foreign stock indices in developed markets. Interest on the dedicated notes and short-term fixed income investments is exchanged for international stock returns, and the total notional amount of the swap agreements is invested in the approximate proportions of the S&P/Citigroup Broad Market Index (BMI) Europe and Pacific Composite (EPAC) country weightings in related indices. Use of swap agreements for a core position began in 1993, an American Depository Receipts (ADR) and index-related security portfolio was added in June of 1999 to increase portfolio management flexibility, and a country fund portfolio with targeted capitalization was added in September of 2002 to improve exposure to the smallest companies in the BMI index.

The combination of notes, dedicated short-term investments and equity swap agreements was valued at $966.0 million on September 30, 2006. That valuation included a net unrealized gain of $264.8 million on equity index exposures and an unrealized gain of $0.5 million on LIBOR note investments held. The combined swap agreements, notes and short-term investments together continue to perform like a stock index fund that realizes all gains and losses on a rolling three year basis. During fiscal year 2006, $139.8 million of gains on equity exposures were realized, $9.2 million of interest in excess of obligations on completed swaps was recognized, and $132 thousand of losses on LIBOR notes were realized.

At the close of fiscal year 2006, the International Equity - Passive pool represented 10.5% of total investments. This compares to 11.2% for fiscal year 2005. The following summarizes the System's 19.5% ownership share of the International Equity Pool - Passive at September 30, 2006:

Report on Investment Activity (Continued)

International Equity Pool - Passive
(in thousands)

Short Term Pooled Investments	$	223,664
Equities		147,575
Fixed Income Securities		495,090
Market Value of Equity Contracts		261,258
Accrued dividends and interest		3,991
Total	**$**	**1,131,578**

International Equities Pool – Active

The investment objective is to generate a rate of return from investment in common stocks and equivalents that exceeds the S&P Citigroup Broad Market Index (BMI) World Ex-United States. That benchmark is impacted by foreign currency exchange rate changes.

In fiscal year 2005, the System invested in AllianceBernstein International Style Blend, a mix of Large Cap Growth and Value, and in fiscal year 2006 achieved a total rate of return of 18.8% vs. Citigroup Broad Market Index World ex. U.S. of 19.3%. During fiscal year 2006, investments were made in the following funds: The Wellington Trust Company International Research Equity Fund, which for a nine month period achieved a total rate of return of 15.4% and the State Street Global Asset International Alpha Select Pool which achieved a total rate of return of 17.0%. For the same nine month period the benchmark S&P Citigroup Broad Market Index World ex. U.S. achieved a return of 13.9%.

At the close of fiscal year 2006, the International Equity - Active pool represented 1.8% of total investments. This compares to 0.6% for fiscal year 2005. The following summarizes the System's ownership share and composition of the pool at September 30, 2006:

International Equity Pool - Active
(in thousands)

	AllianceBernstein International	Wellington International	SSGA International
Total Investment	$70,491	$57,068	$69,557
Ownership Percentage	19.6%	20.0%	20.0%

Alternative Investments Pool

The Alternative Investments pool objective is to meet or exceed the S&P 500 Index plus 300 basis points for all private equity pools over long time periods.

Alternative Investments are investments in the private equity market, primarily through limited partnerships. The following summarizes the weightings of the pool as of September 30, 2006:

Buyout Funds	56.5 %
Special Situation Funds	13.1
Venture Capital Funds	11.8
Fund of Funds	11.3
Mezzanine Funds	4.1
Hedge Funds	1.8
Short Term Investments	1.4
Total	**100.0** %

Report on Investment Activity (Continued)

The Alternative Investments pool had a return of 26.3% for the fiscal year ended September 30, 2006, versus the S&P 500 Index plus 300 basis points of 13.9%.

Credit Suisse Asset Management (CSAM) manages the stock distributions of the Alternative Investments. The CSAM pool return for the fiscal year ending September 30, 2006 was (19.8%).

At the close of fiscal year 2006, the Alternative Investments pool represented 12.0% of total investments and Credit Suisse Asset Management represented 0.01% of total investments. This compares to 11.0% for Alternative and 0.1% for CSAM for fiscal year 2005. The following summarizes the System's ownership share and composition of the Alternative Investments pool and the Credit Suisse Asset Management pool at September 30, 2006:

Alternative Investments Pool
(in thousands)

	Alternative	CSAM
Short Term Pooled Investments	$ 17,700	$ -
Equities	1,284,973	125
Settlement Proceeds Receivable	-	733
Total	**$ 1,302,673**	**$ 858**
Ownership Percentage	18.7%	16.3%

Real Estate Pool

The Real Estate pool seeks favorable returns through rental income and appreciation of real estate investments. Real estate investments are typically held through various legal investment entities, such as limited partnerships or limited liability companies, established for the specific purpose of owning, leasing, managing, financing, or developing real estate and real estate related investments. Independent third parties regularly value the real estate investments to establish current market values.

The Real Estate pool diversifies its holdings by:

- Geographic region **-** The pool is broadly diversified geographically. Emphasis is placed upon U.S. real estate investments, but may also include foreign real estate investments that are not expected to exceed ten percent of the value of the pool.
- Property (size and value) **-** The pool diversifies its holdings so that it is not concentrated in a few large real estate assets.
- Property type **-** The pool is diversified by type of property as summarized in the table below.

Multi-family apartments	24.5	%
Commercial office buildings	22.1	
Hotels	15.1	
Retail shopping centers	15.1	
Industrial warehouse buildings	9.8	
Senior Living	4.2	
Short Term Investments	3.6	
Land	2.9	
For Sale Housing	2.7	
Total	**100.0**	**%**

Report on Investment Activity (Continued)

The Real Estate pool generated a return of 18.9% for fiscal year 2006, while the benchmark return was 16.3%. The benchmark is the National Council of Real Estate Investment Fiduciaries Property Index less 130 basis points. The Real Estate pool benefited from a robust real estate market. During the year the pool had strong appreciation and also realized strong gains on asset sales.

At the close of fiscal year 2006, the Real Estate pool represented 8.7% of total investments. This compares to 8.5% for fiscal year 2005. The following summarizes the System's 21.9% ownership share of the Real Estate pool at September 30, 2006:

Real Estate Pool
(in thousands)

Short Term Pooled Investments	$	33,867
Equities		912,506
Fixed Income Securities		2
Total	**$**	**946,375**

Government Bond Pool

The objectives are to maximize the rate of return consistent with sound portfolio management principles and to outperform the benchmark, Lehman Brothers Government Index.

The pool invests in a diversified portfolio of government bonds including, but not limited to, treasuries, agencies, and government sponsored enterprises. To achieve above average returns, the pool emphasizes those sectors exhibiting the best risk reward relationship relative to historical norms and the outlook for interest rates.

For the fiscal year ending September 30, 2006, the Government Bond Pool returned 4.3%, which compared favorably to the Lehman Brothers Government Index of 3.3%.

Rates continued to be volatile during the year. Ten-year treasuries started the year at 4.32%, rose to 5.25%, then declined and ended at 4.63%. The yield curve shifted upward and continued to flatten from five to thirty years. From three months to three years the curve inverted.

The following summarizes the security type breakdown of the pool as of September 30, 2006:

U.S. Agency	61.8	%
GNMA	18.2	
U.S. Guaranteed	8.7	
U.S. Treasury	4.9	
TIPS	4.3	
Short Term Investments/Accruals	2.1	
Total	**100.0**	%

At the close of fiscal year 2006, the Government Bond pool represented 8.4% of total investments. This compares to 8.0% for fiscal year 2005. The following summarizes the System's 19.7% ownership share of the Government Bond pool at September 30, 2006:

Report on Investment Activity (Continued)

Government Bond Pool
(in thousands)

Short Term Pooled Investments	$	11,264
Fixed Income Securities		891,924
Accrued dividends		8,008
Total	**$**	**911,196**

Corporate Bond Pool

The objectives are to maximize the rate of return consistent with sound portfolio management principles and to outperform the Lehman Brothers Credit Index.

The pool invests in a diversified portfolio of investment grade corporate issues. Such issues are rated in the top four categories by nationally recognized rating agencies. Non-rated bonds are acceptable if they are determined to be of comparable quality. To achieve above average returns, the pool emphasizes those sectors exhibiting the best risk reward relationship relative to historical norms and the outlook for interest rates.

For the fiscal year ending September 30, 2006, the Corporate Bond pool returned 3.6% compared to the Lehman Brothers Credit Index of 3.4%. The pool's performance improved as the year progressed due to the decline in rates later in the year.

The following summarizes the security type breakdown of the pool as of September 30, 2006:

Financials	29.4	%
Short Term Investments/Accruals	15.6	
Health Care	12.3	
Industrials	10.3	
Consumer Discretionary	9.0	
Consumer Staples	8.8	
Utilities	5.1	
Other	4.9	
Materials	2.6	
Information Technology	2.0	
Total	**100.0**	**%**

At the close of fiscal year 2006, the Corporate Bond pool represented 6.0% of total investments. This compares to 8.0% for fiscal year 2005. The following summarizes the System's 19.1% ownership share of the Corporate Bond pool at September 30, 2006:

Corporate Bond Pool
(in thousands)

Short Term Pooled Investments	$	95,043
Fixed Income Securities		549,629
Accrued interest		6,337
Total	**$**	**651,009**

Fixed Income Core Pools

Five Fixed Income Core managers were selected in fiscal year 2006, and they began managing assets for the System beginning March 31, 2006. Their investment objective is to generate a rate of return exceeding the Lehman Aggregate Index net of fees.

Report on Investment Activity (Continued)

The System hired Delaware Investments, Dodge & Cox, Dupont Capital Management, Fidelity Management Trust, and Metropolitan West Asset Management.

The Fixed Income Core pools combined rate of return from inception to fiscal year end was 3.6%.

At the close of fiscal year 2006, the Fixed Income Core pools represented 1.0% of total investments. The following summarizes the System's ownership share and composition of the five Fixed Income Core pools at September 30, 2006:

Fixed Income Core Pools
(in thousands)

	Delaware Fixed Income Core	Dodge & Cox Fixed Income Core	Dupont Fixed Income Core	Fidelity Fixed Income Core	Metro West Fixed Income Core
Total Investment	$20,373	$20,274	$10,181	$30,655	$20,388
Ownership Percentage	19.7%	19.7%	19.7%	19.7%	19.7%

Corporate Fixed Income Manager Pools

Four Corporate Fixed Income managers were selected in fiscal year 2006, and they began managing assets for the System beginning September 15, 2006. Their investment objective is to generate a rate of return exceeding the Lehman Credit Index net of fees.

The System hired AllianceBernstein, Prudential Financial, Western Asset, and Taplin, Canida & Habacht.

The Corporate Fixed Income Manger pools combined rate of return from inception to fiscal year end was 0.7%.

At the close of fiscal year 2006, the Corporate Fixed Income Manger pools represented 0.9% of total investments. The following summarizes the System's ownership share and composition of the four Corporate Fixed Income Manager pools at September 30, 2006:

Corporate Fixed Income Manager Pools
(in thousands)

	Alliance Bernstein Corporate	Prudential Financial Corporate	Western Asset Corporate	Taplin, Canida & Habacht Corporate
Total Investment	$19,786	$34,702	$19,825	$24,623
Ownership Percentage	19.7%	19.7%	19.7%	19.7%

Short Term Investment Pool

The objective of the Short Term Investment pool is to closely match the return performance of its benchmark, the 30 day Treasury bill. The Short Term Investment pool return for the fiscal year was 4.6% versus the benchmark's 4.4%.

Potential areas of investment are:

- Obligations of the United States or its agencies.
- Banker's acceptances, commercial accounts, certificates of deposit or depository receipts.
- Repurchase agreements for the purchase of securities issued by the US government or its agencies.
- Commercial paper rated at the time of purchase within the two highest classifications established by not less than two national rating services as determined by the State Treasurer.

Report on Investment Activity (Continued)

As of September 30, 2006, the Short Term Investment pool was 100% invested in commercial paper because of its advantages in yield and flexibility in maturities.

At the close of fiscal year 2006, the Short Term Investment pool represented 2.2% of total investments. This compares to 3.7% for fiscal year 2005. The System's ownership of the Short Term Investment Pool at September 30, 2006, was $243,727,612 composed of fixed income securities and equity in common cash.

Tactical Asset Allocation Pool

The Tactical Asset Allocation (TAA) pool was established in June 2006 to allow the System more flexibility in achieving its investment goals. The TAA can be used to capitalize on shorter-term windows of investment opportunities without disturbing the return/risk profiles of the longer-term strategies of the underlying investment pools.

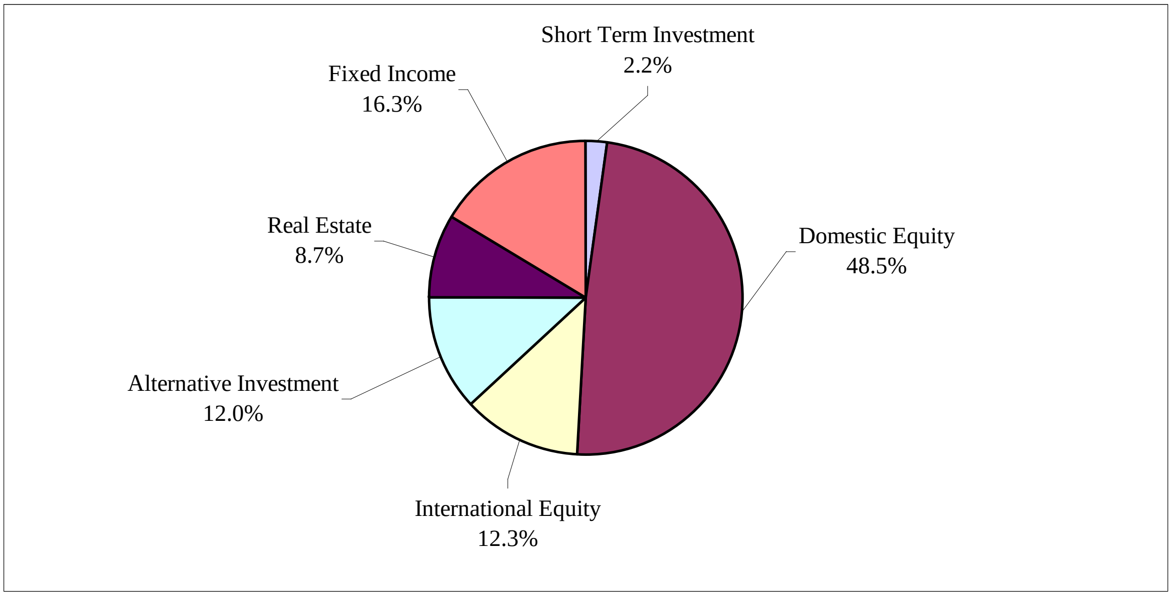
The Tactical Asset Allocation pool return from inception to fiscal year end was 7.5%.

At the close of fiscal year 2006, the Tactical Asset Allocation pool represented 0.6% of total investments. The following summarizes the System's 19.6% ownership share of the Tactical Asset Allocation pool at September 30, 2006:

Tactical Asset Allocation Pool
(in thousands)

Net Equities	$	6,569
Fixed Income Securities		56,717
Total	**$**	**63,286**

Asset Allocation – Security Type Only



INVESTMENT SECTION

Investment Results for the Period Ending September 30, 2006

Investment Category	Current Year	Annualized Rate of Return [1] 3 Years	5 Years	10 Years
Total Portfolio	12.8 %	12.7 %	8.0 %	8.8 %
Total Domestic Equity	10.8	12.0	7.4	8.6
S&P 1500 Index	10.3	12.8	7.7	9.0
Large Cap Value Pool	15.8	15.9		
Large Cap Growth Pool	7.2	7.5		
Mid Cap Pool	7.1			
Small Cap Pool	8.1	12.4		
S&P 500 Index Pool	10.8	12.3		
S&P MidCap Index Pool	6.9	15.4		
S&P Small Cap Index Pool	7.5	17.5		
International Equity Pool - Passive	17.5	21.3	12.8	8.2
S&P Citigroup BMI - EPAC - 50/50	18.5	22.3	13.4	7.8
International Equity Pool - Active	19.7			
Alternative Investments Pool	26.3	23.6	9.7	12.0
S&P 500 Index plus 300 Basis Points	13.9	15.4	10.3	12.1
Credit Suisse Asset Management (Stock Distributions)	(19.8)	(8.2)		
Real Estate Pool	18.9	13.7	11.1	11.4
NCREIF Property Blended Index [2]	16.3	15.4	11.6	11.7
Total Fixed Income	4.0	3.4	4.7	6.3
Lehman Brothers Government/Credit	3.3	3.1	5.0	6.5
Government Bond Pool	4.3	3.6		
Corporate Bond Pool	3.6	3.3		
Short Term Investment Pool	4.6	2.7	2.4	4.2
30 Day Treasury Bill	4.4	2.6	2.2	3.5

[1] Calculations used a time-weighted rate of return based on the market rate of return in accordance with industry standards.

[2] As of 10/1/05, index is NCREIF less 130 bp. History prior to 10/1/05 reflects NCREIF less 75 bp.

Largest Assets Held

Largest Stock Holdings (By Market Value)[1]
September 30, 2006

Rank	Shares	Stocks	Market Value
1	2,423,641	Exxon Mobil Corporation	$ 162,626,304
2	3,947,987	General Electric Corporation	139,363,945
3	2,436,660	Citigroup Incorporated	121,028,895
4	1,966,534	Bank of America Corporation	105,347,238
5	3,476,787	Microsoft Corporation	95,020,590
6	3,215,547	Pfizer Incorporated	91,192,911
7	1,220,630	American International Group	80,878,920
8	1,242,385	Proctor and Gamble Corporation	77,003,041
9	1,170,428	Johnson and Johnson	76,007,604
10	1,602,721	JP Morgan Chase & Co	75,263,782

Largest Bond Holdings (By Market Value)[1]
September 30, 2006

Rank	Par Amount	Description	Market Value
1	$ 58,880,346	Canadian Imperial Bank 0% Coupon Due 6-14-2007	$ 56,717,082
2	44,622,145	U.S. Treasury Strip 0% Coupon Due 11-15-2011	44,350,396
3	37,348,932	Treasury Inflation Index Due 7-15-2014	39,492,543
4	39,062,257	Bank Nova Scotia 5.38188% FRN Due 10-12-2007	39,063,741
5	38,830,488	US Bank NA 5.37% FRN Due 4-5-2007	38,865,008
6	29,296,693	Household Finance Corporation 5.47375% FRN Due 10-22-2007	29,373,421
7	28,910,411	Wells Fargo & Company 5.42375% FRN Due 9-28-2007	28,937,500
8	28,910,411	Canadian Imperial Bank 5.42% FRN Due 1-5-2007	28,910,758
9	25,390,467	Citigroup Global Markets 5.555% FRN Due 1-30-2007	25,400,953
10	21,484,241	JP Morgan Chase & Co 5.50% FRN Due 1-5-2007	21,496,294

[1] A complete list of holdings is available from the Michigan Department of Treasury.

The System's assets are commingled in various pooled accounts. Amounts, par value and number of shares represent the System's pro-rata share based on its ownership of the investment pools.

Schedule of Investment Fees

The State Treasurer is the investment fiduciary and custodian of the System's funds pursuant to State law. Outside advisors are utilized to augment the State Treasurer's internal staff. Only 26.2% of the total investment portfolio is managed by fully discretionary outside advisors. The Michigan Department of Treasury's cost of operations applicable to the retirement system for the fiscal year end amounted to $2,021 thousand or two and five tenths basis points (.025%) of the market value of the portfolio.

Act 380 of the Public Acts of 1965 created an Investment Advisory Committee (Committee) comprised of the directors of the Department of Labor and Economic Growth and the Department of Management and Budget, or their duly authorized representatives, and three public members appointed by the Governor with the advice and consent of the Senate. The public members serve without pay, but may be paid actual and necessary travel and other expenses. The Committee meets quarterly to review investments, goals and objectives and may submit recommendations to the State Treasurer. The Committee may also, by a majority vote, direct the State Treasurer to dispose of any holding, which in the Committee's judgment is not suitable for the fund involved, and may by unanimous vote direct the State Treasurer to make specific investments.

Schedule of Investment Fees

Investment Managers' Fees:

	Assets under Management (in thousands)	Fees (in thousands)	Basis Points[1]
State Treasurer	$ 8,000,276	$ 2,021	2.5
Outside Advisors for			
Fixed Income	200,807	43	2.1
Mid Cap Equity	230,784	886	38.4
Small Cap Equity	103,922	702	67.5
International Equity	337,747	554	16.4
Alternative	1,284,993	10,335	80.4
Real Estate	677,388	601	8.9
Total	$ 10,835,917	$ 15,142	216.2

Other Investment Services Fees:

Assets in Custody	$ 10,592,189	$ 408	
Securities on Loan	1,655,553	357	

[1] Outside Advisors Fees are netted against the income for Fixed Income, Small Cap Equity, Mid Cap Equity, and International Equity. For Alternative partnership agreements that define the management fees, the asset management fees range from 150 to 250 basis points of the committed capital. For Real Estate, the asset management fees range from 50 to 150 basis points. Alternative and Real Estate fees, in most cases, are included in the net income of the partnership and are not reflected in the Schedule of Fees.

Schedule of Investment Commissions

	Fiscal Year Ended September 30, 2006						
	Actual Commissions Paid [1]	Actual Number of Shares Traded[1]	Average Commission Rate Per Share	Estimated Trade Costs Per Share	Estimated Research Costs Per Share	Estimated Trade Costs	Estimated Research Costs
Investment Brokerage Firms:							
ADP Clearing & Outsourcing Services, Inc.	$ 109	$ 2,183	$ 0.05	$ 0.02	$ 0.03	$ 44	$ 65
Baird, Robert W., Company Inc.	241	4,817	0.05	0.03	0.02	144	96
Banc/America Secur.LLC Montgomey Div.	15,621	466,346	0.03	0.01	0.02	4,663	10,958
Bear Stearns & Co Inc.	248,021	10,316,689	0.02	0.01	0.01	103,167	144,854
Bridge Trading	44,096	1,217,891	0.04	0.02	0.02	24,358	19,738
Broadcort Capital	14,893	460,305	0.03	0.02	0.01	9,206	5,687
BNY Brokerage Inc.	228	4,566	0.05	0.03	0.02	137	91
B-Trade Services LLC	441	22,069	0.02	0.01	0.01	221	221
Cantor Fitzgerald & Co.	76,896	2,546,359	0.03	0.01	0.02	25,464	51,433
CIBC World Market Corp.	3,334	66,670	0.05	0.02	0.03	1,333	2,000
Citigroup Global Markets Inc.	321,838	10,830,327	0.03	0.01	0.02	108,304	213,536
Credit Suisse First Boston Corporation	99,541	3,101,782	0.03	0.01	0.02	31,018	68,523
Deutsche Bank Securities Inc.	44,902	1,290,799	0.03	0.01	0.02	12,908	31,994
Friedman Billings Ramsey	317	6,347	0.05	0.03	0.02	190	127
Fulcrum Global Partners	1,081	21,620	0.05	0.03	0.02	649	432
Goldman Sachs	161,152	5,402,359	0.03	0.01	0.02	54,024	107,128
Griswold Company	82,258	4,167,066	0.02	0.01	0.01	41,671	40,587
Howard Weil Division Legg Mason	5,291	132,286	0.04	0.02	0.02	2,646	2,646
Investment Technology Group Inc.	2,311	115,529	0.02	0.01	0.01	1,155	1,155
Instinet	689	34,460	0.02	0.01	0.01	345	345
ISI Group Inc.	50,597	1,358,690	0.04	0.02	0.02	27,174	23,424
Janney Montgomery, Scott Inc.	72	1,436	0.05	0.03	0.02	43	29
J P Morgan Securities Inc.	97,824	2,673,665	0.04	0.02	0.02	53,473	44,350
Jefferies Company Inc.	1,017	24,294	0.04	0.02	0.02	486	531
Labranche Financial (MARA)	198	9,915	0.02	0.01	0.01	99	99
Leerink Swann & Co.	17,851	466,596	0.04	0.02	0.02	9,332	8,520
Lehman Brothers Inc.	223,238	6,947,447	0.03	0.01	0.02	69,474	153,764
Liquidnet Inc.	1,249	62,448	0.02	0.01	0.01	624	624
Merrill Lynch, Pierce, Fenner & Smith, Inc.	141,857	4,420,083	0.03	0.01	0.02	44,201	97,656
Midwest Research Securities	1,237	24,733	0.05	0.02	0.03	495	742
Mischler Financial Group, Inc.	7,592	204,598	0.04	0.02	0.02	4,092	3,501
Morgan Keegean Co Inc.	367	7,333	0.05	0.02	0.03	147	220
Morgan Stanley Co Inc.	195,915	6,036,647	0.03	0.01	0.02	60,366	135,548
OTA Research	30,793	857,494	0.04	0.02	0.02	17,150	13,643
Pershing LLC	107	5,338	0.02	0.01	0.01	53	53
Prudential Equity Group	118,827	3,623,475	0.03	0.01	0.02	36,235	82,593
Raymond James and Associates Inc.	1,484	37,098	0.04	0.02	0.02	742	742
SG Americas Securities LLC	1,970	41,606	0.05	0.03	0.02	1,248	722
S.G. Cowen & Co., LLC	60,251	1,726,689	0.03	0.01	0.02	17,267	42,984
Sanford Bernstein Co LLC	72,241	2,228,444	0.03	0.01	0.02	22,284	49,956
Stifel Nicolaus & Co Inc.	1,480	29,605	0.05	0.03	0.02	888	592
Suntrust Capital Markets Inc.	501	14,364	0.03	0.02	0.01	287	213
Thomas Weisel Partners	1,786	39,711	0.04	0.02	0.02	794	992
US Bancorp Piper Jaffray Inc.	166	3,316	0.05	0.03	0.02	99	66
UBS Securities LLC	161,662	5,279,763	0.03	0.01	0.02	52,798	108,864
Wachovia Capital Markets, LLC	707	17,664	0.04	0.02	0.02	353	353
Wayne Company	6,658	166,456	0.04	0.02	0.02	3,329	3,329
Weeden & Co.	478	9,562	0.05	0.03	0.02	287	191
WR Hambrecht & Co.	16	329	0.05	0.03	0.02	10	7
	$ 2,321,401	76,529,269	$ 0.03 (2)	$ 0.02	$ 0.01	845,477	$ 1,475,924

(1) Commissions are included in purchase and sale prices of investments. The commissions and shares represent the System's pro-rata share (based on ownership) of commisssion and share transactions in the investment pools.

(2) The average commission rate per share for all brokerage firms.

Investment Summary

Fiscal Year Ended September 30, 2006

	Market Value (a)	Percent of Total Market Value	Investment & Interest Income (b)	Percent of Investment & Interest Income
Fixed Income Pools	$ 1,763,011,727	16.3%	$ 67,743,736	5.4%
Domestic Equity Pools	5,250,576,635	48.5%	514,539,082	40.6%
Real Estate Pool	946,375,282	8.7%	160,708,496	12.7%
Alternative Investment Pools	1,303,531,489	12.0%	293,537,817	23.2%
International Equities Pools	1,328,694,117	12.3%	217,158,043	17.1%
Short Term Investment Pools	243,727,612	2.2%	12,641,047	1.0%
Total	$ 10,835,916,862	100.0%	$ 1,266,328,221	100.0%

(a) Market value excludes $1,699,064,634 in cash collateral for security lending for fiscal year 2006.

(b) Total Investment & Interest Income excludes net security lending income of $1,492,117.

Investment Summary (Continued)

Fiscal Year Ended September 30, 2005

	Market Value (a)	Percent of Total Market Value	Investment & Interest Income (b)	Percent of Investment & Interest Income
Fixed Income:				
Government Bond Pool	$ 806,950,266	8.0%	$ 25,741,364	2.2%
Corporate Bond Pool	805,164,734	8.0%	16,861,446	1.4%
Total Fixed Income Pools	1,612,115,000	16.0%	42,602,810	3.6%
Equity Pools	4,918,519,900	48.9%	531,331,780	44.9%
Real Estate Pool	856,145,584	8.5%	108,317,544	9.1%
Alternative Investment Pools	1,119,252,745	11.1%	235,171,525	19.9%
International Equities Pools	1,182,264,943	11.8%	258,219,137	21.8%
Short Term Investment Pools	370,571,193	3.7%	8,282,717	0.7%
Total	$ 10,058,869,365	100.0%	$ 1,183,925,513	100.0%

(a) Market value excludes $566,872,723 in cash collateral for security lending for fiscal year 2005.

(b) Total Investment & Interest Income excludes net security lending income of $794,176.

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ACTUARIAL SECTION

Actuary's Certification

SEGAL

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Michael J. Karlin, M.A.A.A.
Senior Vice President & Actuary
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December 7, 2006

Ms. Lisa Webb Sharpe
Director
Department of Management and Budget and
Retirement Board
Michigan State Employees Retirement System
P.O. Box 30176
Lansing, Michigan 48909

Ladies and Gentlemen:

The Michigan State Employees Retirement System (MSERS) is funded on an actuarial reserve basis. The basic financial objective of MSERS is to establish and receive contributions that remain approximately level as a percentage of active member payroll over a long period of years.

Actuarial valuations are prepared annually to determine MSERS's actuarial liabilities and the employer contributions required to fund the System in accordance with the actuarial reserve funding provisions of the governing State Statute. The most recent actuarial valuation as of September 30, 2005 included a total of 86,771 members of MSERS. The actuarial value of MSERS's assets amounted to approximately $9.90 billion on September 30, 2005.

The assumptions used in the 2005 valuation produce valuation results which we consider to be reasonably indicative of the plan's underlying cost. Also, in our opinion, the actuarial assumptions and methods used for funding purposes meet the parameters for the disclosures presented in the financial section by GASB Statement No. 25.

Our actuarial valuation of MSERS as of September 30, 2005 was performed by qualified actuaries in accordance with accepted actuarial procedures. In our opinion, the calculated contribution rate meets the fundamental objectives of State law. Based on the 2005 valuation results, it is also our opinion that the Michigan State Employees Retirement System continues in sound condition, in accordance with actuarial principles of level cost financing.

Most of the information used in the supporting schedules in the Actuarial and Statistical Sections, as well as the Schedules of Funding Progress and the employer contributions shown in the Schedules of Employer Contributions in the Financial Section of this report were provided by our firm.

Sincerely,

Michael Karlin

Michael Karlin, F.S.A., M.A.A.A.
Senior Vice President & Actuary

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Summary of Actuarial Assumptions and Methods

1. The investment return rate used in making the valuations was 8% per year, compounded annually. This rate of return is not the assumed real rate of return. The real rate of return is the rate of investment return in excess of the inflation rate. Considering other financial assumptions, this investment return rate translates to an assumed long-term real rate of return of 4.5%. Adopted 2004.

2. The healthy life mortality table used in evaluating allowances to be paid was the 1994 Group Annuity Mortality Table, set forward one year for both men and women. Adopted 1998.

3. Sample probabilities of regular, unreduced retirement are shown in Schedule 1 on the next page. Adopted 2004.

4. Sample probabilities of withdrawal from service and disability, together with individual pay increase assumptions, are shown in Schedule 2 on the next page of this report. Adopted 2004.

5. The active member population is closed to new hires. This will result in a gradual reduction in the total active member payroll over time.

6. An individual entry age actuarial cost method of valuation was used in determining age and service allowance actuarial liabilities and normal cost. Adopted 1975. Unfunded actuarial accrued liabilities are financed over a declining 40-year period for years beginning October 1, 1996. Adopted 1996.

7. The Department of Management and Budget approved the use of market value of assets as of September 30, 1997, for valuation purposes. For investment gains and losses that occur after that date, a 5-year smoothing technique will be used. Specifically, the excess (shortfall) of actual investment income (including interest, dividends, realized and unrealized gains or losses) over the imputed income at the valuation interest rate is considered the gain (loss), which is spread over five years. Adopted 1997.

8. The data including people now covered and about present assets was furnished by the System's administrative staff. Although examined for general reasonableness, the data was not audited by the actuary.

9. The actuarial valuation computations were made by or under the supervision of a Member of the American Academy of Actuaries (MAAA). The assumptions used in the actuarial valuations were adopted by the System's Board after consulting with the actuary.

10. A 5-year experience investigation, covering the period from September 30, 1997 through September 30, 2002 was completed in April 2004. The purpose of the study was to analyze the actual experience of the System versus that anticipated by actuarial assumptions then in use. The combined effect of the recommended changes in assumptions was a decrease in actuarial accrued liabilities of approximately 1.3% and a 5.7% decrease in computed employer contributions. Adopted 2004.

11. Gabriel Roeder Smith & Co. was awarded the actuarial and consulting services contract beginning October 4, 2006.

Summary of Actuarial Assumptions and Methods (Continued)

SCHEDULE 1

Percent of Eligible Active Members Retiring Each Year

Retirement Ages	Correction Officers	Conservation Officers	Other Members
45		16 %	
48		16	
51	25 %	16	
55	15	16	18 %
58	12	15	12
61	15	15	14
64	22	22	20
67	25	25	25
70	50	50	50
75	100	100	100

SCHEDULE 2

Separation From Active Employment Before Age & Service Retirement & Individual Pay Increase Assumptions

Sample Ages	Years of Service	Percent of Active Members Withdrawing Within Next Year (Men and Women)	Percent of Active Members Becoming Disabled w/in Next Year: Non-Duty Disabilities	Percent of Active Members Becoming Disabled w/in Next Year: Duty Disabilities	Percent Increase In Pay During Next Year
All	0	12.00 %			
	1	8.50			
	2	6.50			
	3	5.00			
	4	4.00			
25	5 & Over	3.50	0.03 %	0.05 %	10.74 %
35		2.50	0.10	0.05	4.95
45		2.00	0.34	0.05	4.12
55		1.75	0.62	0.05	3.91
60		1.75	0.82	0.05	3.50

Actuarial Valuation Data

Schedule of Active Member Valuation Data

Valuation Date Sept. 30	Number	Reported Annual Payroll*	Average Annual Pay	% Increase	Average Age	Average Service
1996	63,807	$ 2,515,420	$ 39,422	9.3	43.8	13.0
1997	55,434	2,273,203	41,007	4.0	43.7	13.1
1998	49,717	2,107,996	42,400	3.4	44.8	14.8
1999	49,612	2,213,851	44,623	5.2	45.9	15.8
2000	47,778	2,253,818	47,173	5.7	46.7	16.7
2001	45,852	2,230,562	48,647	3.1	47.4	17.7
2002	43,064	2,133,477	49,542	1.8	48.0	18.6
2003	36,536	1,859,555	50,897	2.7	47.7	17.9
2004	34,749	1,889,410	54,373	6.8	48.4	19.0
2005	33,770	1,880,179	55,676	2.4	49.3	20.0

* In thousands of dollars.

Schedule of Changes in the Retirement Rolls

Year Ended Sept. 30	Added to Rolls		Removed from Rolls		Rolls–End of Year		% Increase in Annual Allowances	Average Annual Allowances
	No.	Annual Allowances*	No.	Annual Allowances*	No.	Annual Allowances*		
1996	1,595	$ 24,527	1064	$ 7,288	31,093	$ 307,933	5.9 %	$ 9,904
1997	6,098	121,005	1,068	7,878	36,123	421,060	36.7	11,656
1998	1,279	21,085	1,217	9,689	36,185	432,456	2.7	11,951
1999	1,409	21,227	1,248	9,516	36,346	444,167	2.7	12,221
2000	1,540	22,421	1,181	2,619	36,705	463,969	4.5	12,640
2001	1,648	22,501	1,242	15,063	37,111	471,407	1.6	12,703
2002	3,806	80,871	1,251	5,310	39,666	546,968	16.0	13,789
2003 **	6,448	163,673	623	2,034	45,491	708,607	29.6	15,577
2004	1,561	23,195	1,433	2,715	45,619	729,087	2.9	15,982
2005	1,542	25,024	1,360	6,683	45,801	747,428	2.5	16,319

*In thousands of dollars
**Revised actuarial data

Prioritized Solvency Test

The System's funding objective is to meet long term benefit promises through contributions that remain approximately level from year to year as a percent of member payroll. If the contributions to the System are level in concept and soundly executed, the System will pay all promised benefits when due, the ultimate test of financial soundness. Testing for level contribution rates is the long-term solvency test.

A prioritized solvency test is another means of checking a system's progress under its funding program. In a short condition test, the plan's present assets (cash and investments) are compared with: (1) active member contributions on deposit; (2) the liabilities for future benefits to present retired lives; and (3) the liabilities for service already rendered by active and inactive members. In a system following the discipline of level percent of payroll financing, the liabilities for active member contributions on deposit (liability 1) and the liabilities for future benefits to present retired lives (liability 2) will be fully covered by present assets (except in rare circumstances). In addition, the liabilities for service already rendered by active members (liability 3) are normally partially covered by the remainder of present assets. Generally, if the System has been using level-cost financing, the funded portion of liability 3 will increase over time. Liability 3 being fully funded is not necessarily a by-product of level percent of payroll funding methods.

The schedule below illustrates the history of the liabilities of the System and is indicative of the System's policy of following the discipline of level percent of payroll financing.

($ in millions)

	Actuarial Accrued Liability (AAL)							
	(1)	(2)	(3)					
Valuation Date Sept. 30	Active Member Contributions	Retirants and Beneficiaries	Active and Inactive Members (Employer Financed Portion)	Valuation Assets	Portion of AAL Covered by Assets (1)	(2)	(3)	(4) [3]
1996	$ 55	$ 2,844	$ 4,248	$ 6,678	100 %	100 %	89.0 %	93.4 %
1997 [1,2]	3	4,300	3,798	8,834	100	100	119.3	109.0
1998	27	4,360	3,987	9,109	100	100	118.4	108.8
1998 [2]	27	4,484	3,986	9,109	100	100	115.4	107.2
1999	35	4,538	4,456	9,648	100	100	113.9	106.9
2000	29	4,659	4,786	10,337	100	100	118.0	109.1
2001	34	4,677	5,167	10,633	100	100	114.6	107.6
2002	123	5,512	5,118	10,616	100	100	97.3	98.7
2003	57	7,386	4,318	10,441	100	100	69.4	88.8
2004 [2]	78	7,503	4,423	10,149	100	100	58.1	84.5
2005	97	7,607	4,696	9,897	100	100	46.7	79.8

[1] Revised asset valuation method.

[2] Revised actuarial assumptions.

[3] Percents funded on a total valuation asset and total actuarial accrued liability basis.

Analysis of Financial Experience

Gains/(Losses) in Accrued Liabilities During Year Ended September 30, 2005
Resulting from Differences Between Assumed Experience & Actual Experience

	Type of Activity	Gain/(Loss)
1.	**Retirements (including Disability Retirement).** If members retire at older ages or with lower final average pay than assumed, there is a gain. If younger ages or higher average pays, a loss.	$28,122,248
2.	**Withdrawal From Employment** (including death-in-service). If more liabilities are released by withdrawals and deaths than assumed, there is a gain. If smaller releases, a loss.	(3,113,930)
3.	**Pay Increases.** If there are smaller pay increases than assumed, there is a gain. If greater increases, a loss.	57,576,146
4.	**Investment Income.** If there is greater investment income than assumed, there is a gain. If less income, a loss.	(583,958,395)
5.	**Death After Retirement.** If retirants live longer than assumed, there is a loss. If not as long, a gain.	(43,760,372)
6.	**New entrants.**	(37,784,957)
7.	**Other.** Miscellaneous gains and losses resulting from data adjustments, timing of financial transactions, etc.	(17,606,054)
8.	**Composite Gain (or Loss) During Year**	($600,525,314)

Summary of Plan Provisions

Our actuarial valuation of the System as of September 30, 2005, is based on the present provisions of the Michigan State Employees' Retirement Act, which are summarized in this section.

Regular Retirement (no reduction factor for age)

Eligibility — Age 55 with 30 years service, or age 60 with 10 or more years of service. Corrections Officers may retire at age 51 with 25 or more years of service, or age 56 with 10 or more years of service. Conservation Officers may retire after 25 years of service regardless of age.

Annual Amount — Total service times 1.5% of FAC. For members with 20 or more years of service, a $3,000 minimum annual benefit is payable. Corrections Officers receive an additional temporary supplement to age 62 equal to the product of supplemental service times 0.5% of FAC. Conservation Officers retiring after 25 years receive a benefit equal to 60% of FAC.

Final Average Compensation — Regular retirement benefit is based on final average compensation (FAC), which is the average of highest 3 consecutive years (2 years for Conservation Officers).

Early Retirement (age reduction factor used)

Eligibility — Age 55 with 15 or more years of service.

Annual Amount — Computed as regular retirement benefit but reduced by 0.5% for each month under age 60.

Deferred Retirement (vested benefit)

Eligibility — 10 years of service (5 years for unclassified persons in the executive or legislative branch). Benefit commences at age 60.

Annual Amount — Computed as regular retirement benefit based on service and FAC at termination.

Duty Disability Retirement

Eligibility — No age or service requirement.

Annual Amount — Disability after age 60: Computed as regular retirement benefit with minimum benefit based on 10 years service. Disability prior to age 60: To age 60, benefit is two-thirds of FAC but limited to $6,000 per year. Additional limitation, such that benefit plus workers' compensation does not exceed final compensation. After age 60, benefit is recomputed as a regular retirement benefit with service granted for period in receipt of disability benefit before age 60 (benefit not reduced after age 60).

Non-Duty Disability Retirement

Eligibility — 10 years of service.

Annual Amount — Computed as regular retirement benefit based on service and FAC at time of disability. Minimum annual benefit is $600.

Summary of Plan Provisions (Continued)

Duty Death Before Retirement

Eligibility — No age or service requirement. Also applies to duty disability retirants who die within 3 years of disability and before age 60.

Annual Amount — Accumulated employee contributions are refunded. Surviving spouse receives annual benefit of one-third of final compensation until death. Unmarried children under age 18 each receive an equal share of one-fourth of final compensation (if no spouse each child receives one-fourth, to a maximum of one-half for all children). If no spouse or eligible children, each dependent parent receives one-sixth of final compensation. Total benefits payable are limited to $2,400 per year. Additional limitation such that benefits plus workers' compensation does not exceed final compensation.

Non-Duty Death Before Retirement

Eligibility — 10 years of service. In the case of a deceased vested former member, the survivor benefit commences when the deceased former member would have attained age 60.

Annual Amount — Computed as regular retirement benefit but reduced in accordance with a 100% joint and survivor election.

Post-Retirement Cost-of-Living Adjustments

One-time upward adjustments have been made in 1972, 1974, 1976, 1977 and 1987. Beginning in 1983, some benefit recipients share in a distribution of a portion of investment income earned in excess of 8% annually (supplemental payment). Beginning in 1988, all benefit recipients are eligible for automatic 3% annual (non-compounded) benefit increases, with a maximum $300 annual increase. Eligibility for the above benefits:

Retired before October 1, 1987	Greater of supplemental payment or the combination of the 1987 onetime adjustment and the automatic increases.
Retired on or after October 1, 1987	Automatic increases only.

Post-Retirement Health Insurance Coverage

Persons in receipt of retirement allowance (including members who did not retire directly from the System, but come from a vested deferred status), and their dependents, are eligible for 95% System paid health insurance coverage and 90% System paid dental and vision insurance.

Member Contributions

None.

Defined Contribution

New employees hired on or after March 31, 1997, become participants in Tier 2 (i.e., the defined contribution plan) rather than Tier 1 (i.e., the above described defined benefit plan).

Active members on March 30, 1997, had an opportunity to irrevocably elect to terminate membership in Tier 1 and become participants in Tier 2. Elections were in writing and submitted between January 2, 1998, and April 30, 1998. Such members became Tier 2 participants on June 1, 1998, and had the actuarial present value of their Tier 1 accrued benefit transferred into Tier 2 by September 30, 1998.

Summary of Plan Provisions (Continued)

2002 Early Out Window

Members who retired between April 1, 2002, and November 1, 2002, and whose combined age and service equaled 80 points, or who were age 60 or older with 10 or more years of service were eligible to receive a benefit equal to 1.75% of their final average compensation multiplied by years of credited service. Members, who had previously transferred to the Defined Contribution plan, were eligible to receive a benefit equal to 0.25% of their final average compensation multiplied by years of credited service.

STATISTICAL SECTION

STATISTICAL SECTION

This part of the System's comprehensive annual financial report presents detailed information as a context for understanding what the information in the financial statements, note disclosures, and required supplementary information says about the System's overall financial health.

Contents

Financial Trends

These schedules contain trend information to help the reader understand how the System's financial performance and fiscal health has changed over time. The schedules are presented for the last ten fiscal years. Schedules included are:

- Schedule of Pension Plan Revenues by Source
- Schedule of Health Plan Revenues by Source
- Schedule of Pension Plan Expenses by Type
- Schedule of Health Plan Expenses by Type
- Schedule of Changes in Net Assets – Pension Plan
- Schedule of Changes in Net Assets – Health Plan
- Schedule of Benefit and Refund Deductions by Type

Operating Information

These schedules contain contextual information to assist the reader's understanding of how the System's financial information relates to the combination of participating members and the benefits it provides. Schedules are presented for the last ten fiscal years, except where noted. Schedules included are:

- Schedule of Retired Members by Type of Pension Benefit
- Schedule of Retired Members by Type of Health Benefit
- Schedule of Average Benefit Payments – Pension
- Schedule of Average Benefit Payments – Health
- Schedule of Average Benefit Payments – Dental
- Schedule of Average Benefit Payments – Vision
- Ten Year History of Membership

Schedule of Pension Plan Revenues by Source

Last Ten Years

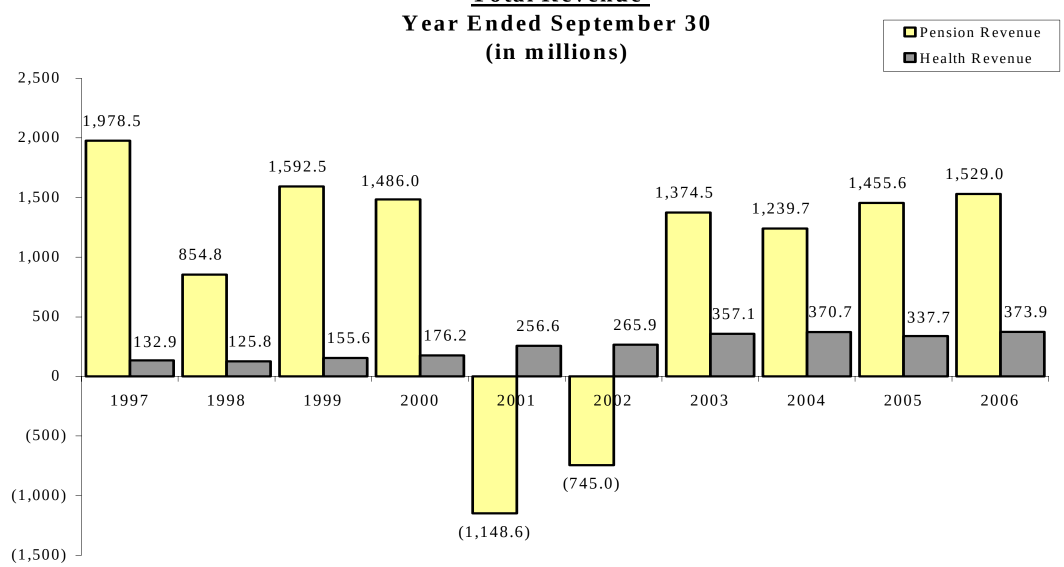
Fiscal Year Ended Sept. 30	Member Contributions	Employer Contributions Dollars	Employer Contributions % of Annual Covered Payroll	Net Investment & Other Income	Total
1997	$ 12,144,153	$ 288,590,215	12.7 %	$ 1,677,780,071	$ 1,978,514,439
1998	5,158,744	147,599,551	7.0	702,058,316	854,816,611
1999	6,186,018	121,119,857	5.5	1,465,196,232	1,592,502,107
2000	4,606,662	121,817,366	5.4	1,359,608,718	1,486,032,746
2001	3,341,381	112,299,808	5.0	(1,264,290,456)	(1,148,649,267)
2002	173,232,835	87,486,128	4.1	(1,005,732,436)	(745,013,473)
2003	80,185,475	79,291,845	4.3	1,215,018,189	1,374,495,509
2004	37,682,883	103,873,294	5.5	1,098,149,414	1,239,705,591
2005	30,395,040	256,433,052	13.6	1,168,811,938	1,455,640,030
2006	9,434,310	270,705,017	N/A	1,248,616,291	1,528,984,846

Schedule of Health Plan Revenues by Source

Last Ten Years

Fiscal Year Ended Sept. 30	Member Contributions	Employer Contributions Dollars	Employer Contributions % of Annual Covered Payroll	Net Investment & Other Income	Total
1997	$ 3,714,213	$ 121,641,412	5.4 %	$ 7,546,437	$ 132,902,062
1998	4,619,101	112,199,628	5.3	8,998,673	125,817,402
1999	4,861,628	144,515,766	6.5	6,219,220	155,596,614
2000	5,056,971	166,833,573	7.4	4,339,752	176,230,296
2001	5,793,284	249,214,002	11.2	1,586,567	256,593,853
2002	6,326,267	257,730,817	12.1	1,842,164	265,899,248
2003	11,144,737	320,838,540	17.2	25,157,754	357,141,031
2004	9,723,230	357,554,699	18.9	3,380,735	370,658,664
2005	10,701,614	324,305,023	17.3	2,712,374	337,719,011
2006	11,528,041	356,674,243	N/A	5,660,782	373,863,066

Total Revenue
Year Ended September 30
(in millions)



Schedule of Pension Plan Expenses by Type

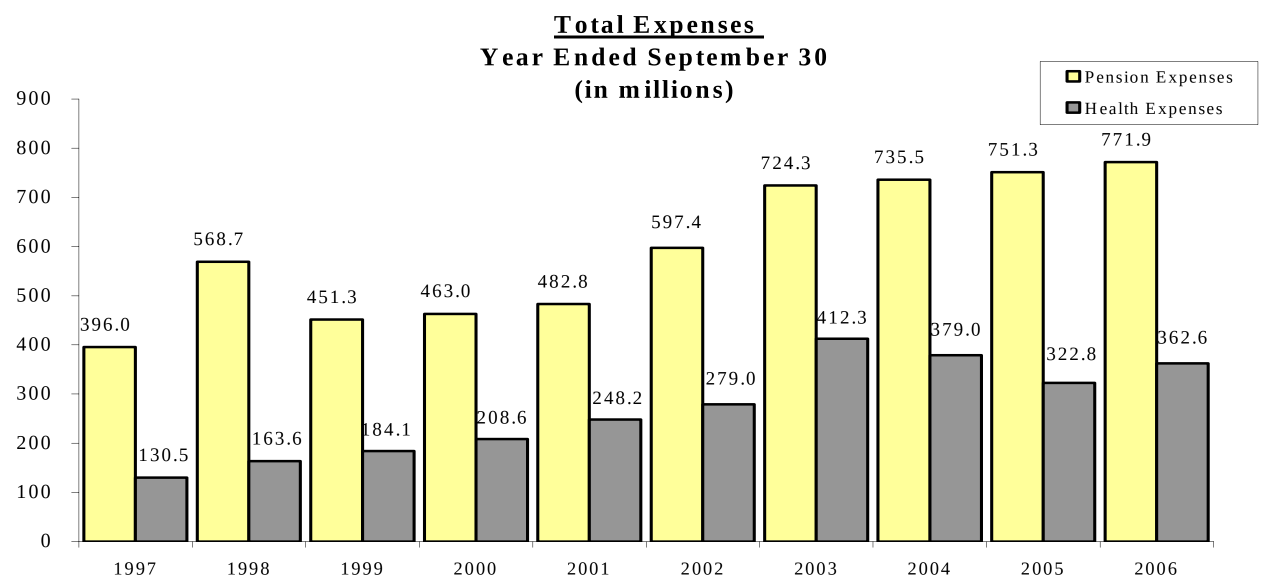
Last Ten Years

Fiscal Year Ended Sept. 30	Benefit Payments	Refunds and Transfers	Administrative and Other Expenses	Total
1997	$ 382,866,379	$ 7,848,649	$ 5,247,943	$ 395,962,971
1998	429,879,875	134,533,763	4,297,092	568,710,730
1999	446,219,254	728,366	4,330,623	451,278,243
2000	458,803,774	222,163	3,954,992	462,980,929
2001	478,525,328	91,699	4,149,284	482,766,311
2002	503,453,879	87,504,459	6,432,819	597,391,157
2003	701,664,432	17,484,652	5,192,039	724,341,123
2004	731,009,109	183,126	4,316,433	735,508,668
2005	746,673,263	306,643	4,297,985	751,277,891
2006	767,000,706	256,533	4,628,043	771,885,282

Schedule of Health Plan Expenses by Type

Last Ten Years

Fiscal Year Ended Sept. 30	Benefit Payments	Refunds and Transfers	Administrative and Other Expenses	Total
1997	$ 130,492,860	$ -	$ -	$130,492,860
1998	163,574,055			163,574,055
1999	184,127,475			184,127,475
2000	208,627,602	8		208,627,610
2001	248,246,380			248,246,380
2002	278,998,333			278,998,333
2003	354,084,838	58,211,100		412,295,938
2004	354,649,665	24,363,516		379,013,181
2005	322,834,138			322,834,138
2006	362,597,685			362,597,685



Schedule of Changes in Net Assets-Pension Plan

Last Ten Years

(in thousands)

	Fiscal Year									
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Member contributions	$ 12,144	$ 5,159	$ 6,186	$ 4,607	$ 3,341	$ 173,233	$ 80,185	$ 37,683	$ 30,395	$ 9,435
Employer contributions	288,590	147,600	121,120	121,817	112,300	87,486	79,292	103,873	256,433	270,705
DC savings subaccount	-	-	-	-	-	-	-	-	-	-
Net investment income	1,677,780	702,058	1,465,196	1,359,606	(1,264,292)	(1,005,733)	1,215,018	1,073,758	1,168,690	1,248,616
Tranfer from other systems	-	-	-	-	-	-	-	26	120	123
Transfer from pension/health benefit plan	-	-	-	-	-	-	-	24,364	-	-
Miscellaneous income	-	-	-	3	2	-	-	2	2	106
Total Additions	$ 1,978,514	$ 854,817	$ 1,592,502	$ 1,486,033	$ (1,148,649)	$ (745,014)	$ 1,374,495	$ 1,239,706	$ 1,455,640	$ 1,528,985
Pension benefits	$ 382,866	$ 429,880	$ 446,219	$ 458,804	$ 478,525	$ 503,454	$ 701,664	$ 731,009	$ 746,673	$ 767,000
Health care benefits	-	-	-	-	-	-	-	-	-	-
Refunds of member contributions	42	19	21	43	15	5	118	163	292	254
Transfer to pension/health benefit plans	-	-	-	-	-	-	17,365	-	-	-
Tranfer to other systems	7,806	134,515	707	179	77	13	2	20	15	3
Administrative expenses	5,248	4,297	4,331	3,955	4,149	6,433	5,192	4,317	4,298	4,628
Total Deductions	$ 395,962	$ 568,711	$ 451,278	$ 462,981	$ 482,766	$ 509,905	$ 724,341	$ 735,509	$ 751,278	$ 771,885
Changes in net assets	$ 1,582,552	$ 286,106	$ 1,141,224	$ 1,023,052	$ (1,631,415)	$ (1,254,919)	$ 650,154	$ 504,197	$ 704,362	$ 757,100

Schedule of Changes in Net Assets - Health Plan

Last Ten Years

(in thousands)

	Fiscal Year									
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Member contributions	$ 3,714	$ 4,619	$ 4,862	$ 5,057	$ 5,793	$ 6,326	$ 11,145	$ 9,723	$ 10,702	$ 11,528
Employer contributions	121,641	112,200	144,516	166,833	249,214	257,731	320,838	357,555	324,305	356,674
DC savings subaccount	-	-	170	574	412	-	-	-	-	-
Net investment income	7,547	8,999	6,049	3,766	1,175	1,842	7,793	3,381	2,712	5,661
Tranfer from other systems	-	-	-	-	-	-	-	-	-	-
Transfer from pension/health							17,365			
benefit plan	-	-	-	-	-	-	-	-	-	-
Miscellaneous income	-	-	-	-	-	-	-	-	-	-
Total Additions	$ 132,902	$ 125,818	$ 155,597	$ 176,230	$ 256,594	$ 265,899	$ 357,141	$ 370,659	$ 337,719	$ 373,863
Pension benefits	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Health care benefits	130,493	163,475	184,128	208,628	248,246	278,998	354,085	354,650	322,834	362,598
Refunds of member contributions	-	-	-	-	-	-	-	-	-	-
Transfer to pension/health benefit plans	-	-	-	-	-	-	58,211	24,364	-	-
Tranfer to other systems	-	-	-	-	-	-	-	-	-	-
Administrative expenses	-	-	-	-	-	-	-	-	-	-
Total Deductions	$ 130,493	$ 163,475	$ 184,128	$ 208,628	$ 248,246	$ 278,998	$ 412,296	$ 379,014	$ 322,834	$ 362,598
Changes in net assets	$ 2,409	$ (37,657)	$ (28,531)	$ (32,398)	$ 8,348	$ (13,099)	$ (55,155)	$ (8,355)	$ 14,885	$ 11,265

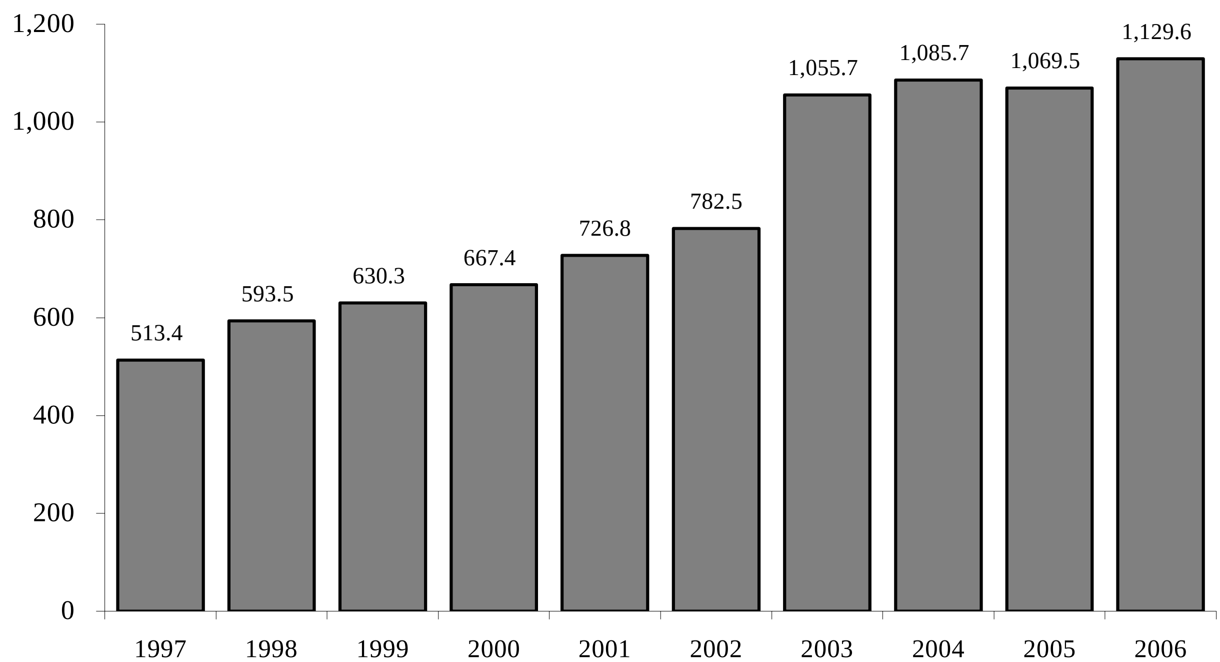
Statistical Section

Schedule of Benefit and Refund Deductions by Type

Last Ten Years

Fiscal Year Ended Sept. 30	Regular Benefits	Disability Benefits	Survivor Benefits	Supplemental Check	Health Benefits	Total	Refunds
1997	$ 331,964,200	$ 26,069,505		$ 24,832,674	$ 130,492,860	$ 513,359,239	42,388
1998	401,855,102	28,024,773			163,574,055	593,453,930	18,555
1999	417,313,133	28,227,807		678,314	184,127,475	630,346,729	21,110
2000	427,500,808	30,867,062		435,904	208,627,602	667,431,376	43,494
2001	444,244,814	33,902,047		378,467	248,246,380	726,771,708	14,900
2002	467,909,032	35,544,847			278,998,333	782,452,212	4,870
2003	664,188,203	37,476,229			354,084,838	1,055,749,270	117,595
2004	690,942,422	40,066,687			354,649,665	1,085,658,774	163,418
2005	704,890,377	41,782,886			322,834,138	1,069,507,401	291,592
2006	676,029,503	37,961,735	$ 53,009,468		362,597,685	1,129,598,391	253,886

Benefit Expenses
Year Ended September 30
(in millions)



Schedule of Retired Members by Type of Pension Benefit

September 30, 2005

Amount of Monthly Benefit	Number of Retirees	Type of Retirement *							
		1	2	3	4	5	6	7	8
$ 1 - 200	738	352	264	15	84	-	12	-	11
201 - 400	3,375	2,120	706	19	423	-	78	7	22
401 - 600	5,467	3,231	669	385	831	18	220	8	105
601 - 800	5,035	3,134	579	3	836	-	245	15	223
801 - 1,000	4,231	2,604	391	2	656	-	208	35	335
1,001 - 1,200	3,980	2,499	271	4	522	-	170	72	442
1,201 - 1,400	3,939	2,647	279	1	295	-	134	71	512
1,401 - 1,600	3,414	2,543	176	-	135	-	88	71	401
1,601 - 1,800	3,055	2,470	130	-	92	-	44	95	224
1,801 - 2,000	2,759	2,358	90	-	37	-	38	123	113
Over 2,000	9,808	8,759	151	1	24	-	65	677	131
Totals	45,801	32,717	3,706	430	3,935	18	1,302	1,174	2,519

* Type of Retirement

1 - Normal retirement for age & service
2 - Survivor payment - normal or early retirement
3 - Duty disability retirement (incl. survivors)
4 - Non-duty disability retirement (incl. survivors)
5 - Survivor payment - duty death in service
6 - Survivor payment - non-duty death in service
7 - Retirees with supplemental benefits for early retirement incentive factors
8 - Retirees with reduced benefits for early retirement reduction factors

Source: The Segal Company

Schedule of Retired Members by Type of Pension Benefit (Continued)

September 30, 2005

Amount Monthly Benefit	Number of Retirees	Selected Option **							
		Reg.	Opt. A	Opt B	Opt. C	Opt. E	Opts E1	Opt. E2	Opt. E3
$ 1 - 200	738	200	214	230	3	68	13	10	-
201 - 400	3,375	1,332	891	715	29	282	57	69	-
401 - 600	5,467	2,491	1,410	852	59	449	89	113	4
601 - 800	5,035	2,171	1,378	870	61	410	54	90	1
801 - 1,000	4,231	1,834	1,193	810	51	233	49	59	2
1,001 - 1,200	3,980	1,812	1,147	716	57	156	33	59	-
1,201 - 1,400	3,939	1,757	1,207	707	65	121	31	47	4
1,401 - 1,600	3,414	1,315	1,087	718	96	112	32	49	5
1,601 - 1,800	3,055	1,174	919	585	135	121	49	59	13
1,801 - 2,000	2,759	939	784	553	108	191	64	97	23
Over 2,000	9,808	3,154	2,542	1,851	607	848	265	432	109
Totals	45,801	18,179	12,772	8,607	1,271	2,991	736	1,084	161

**Selected Option

Reg. - Straight life allowance
Opt. A - 100% survivor option
Opt. B - 50% survivor option
Opt. C - 75% survivor option
Opt. E - Social Security equated
Opt. E1 - Social Security equated w/100% survivor option
Opt. E2 - Social Security equated w/50% survivor option
Opt. E3 - Social Security equated w/75% survivor option

Source: The Segal Company

Schedule of Retired Members by Type of Health Benefit

September 30, 2005

Amount of Monthly Benefit	Eligible Retirees	Type of Other Post - Employment Benefits		
		Health	Dental	Vision
$ 1 – 200	738	494	464	470
201 – 400	3,375	2,614	2,518	2,550
401 – 600	5,467	4,660	4,605	4,628
601 – 800	5,035	4,454	4,404	4,425
801 – 1,000	4,231	3,819	3,792	3,814
1,001 – 1,200	3,980	3,678	3,656	3,668
1,201 – 1,400	3,939	3,668	3,666	3,667
1,401 – 1,600	3,414	3,214	3,208	3,211
1,601 – 1,800	3,055	2,856	2,875	2,874
1,801 – 2,000	2,759	2,603	2,632	2,625
Over 2,000	9,808	9,247	9,345	9,341
Totals	45,801	41,307 *	41,165 *	41,273 *

*Participating member totals displayed in this schedule and the information presented in Note 1 of this report may differ. These variances are the result of a mid-year data conversion.

Schedule of Average Benefit Payments - Pension

Last Ten Years

Payment Periods	Credited Service (Years)							
	0-5	**5-10**	**10-15**	**15-20**	**20-25**	**25-30**	**30+**	**Total**
Period 10/1/95 to 9/30/96:								
Average Monthly Benefit	$ 316	$ 343	$ 375	$ 571	$ 793	$ 1,045	$ 1,340	$ 825
Average Final Average Salary	12,260	25,997	21,206	23,275	25,383	27,175	28,936	25,142
Number of Active Retirants	341	429	5,977	6,311	5,636	5,149	7,250	31,093
Period 10/1/96 to 9/30/97:								
Average Monthly Benefit	$ 367	$ 357	$ 400	$ 632	$ 877	$ 1,272	$ 1,536	$ 971
Average Final Average Salary	11,007	26,932	22,665	25,373	27,707	32,426	33,096	28,415
Number of Active Retirants	396	440	6,207	6,947	6,410	7,030	8,693	36,123
Period 10/1/97 to 9/30/98:								
Average Monthly Benefit	$ 373	$ 369	$ 414	$ 651	$ 901	$ 1,298	$ 1,571	$ 996
Average Final Average Salary	10,322	28,458	23,509	26,087	28,395	33,076	33,906	29,148
Number of Active Retirants	411	449	6,246	6,906	6,389	7,074	8,710	36,185
Period 10/1/98 to 9/30/99:								
Average Monthly Benefit	$ 375	$ 379	$ 433	$ 673	$ 926	$ 1,329	$ 1,600	$ 1,018
Average Final Average Salary	9,939	29,279	24,597	26,881	29,163	33,685	34,435	29,846
Number of Active Retirants	432	457	6,328	6,939	6,421	7,091	8,678	36,346
Period 10/1/99 to 9/30/00:								
Average Monthly Benefit	$ 398	$ 390	$ 453	$ 694	$ 952	$ 1,388	$ 1,656	$ 1,053
Average Final Average Salary	9,908	30,734	25,784	27,734	29,943	34,218	35,149	30,620
Number of Active Retirants	450	454	6,476	6,984	6,488	7,145	8,708	36,705
Period 10/1/00 to 9/30/01								
Average Monthly Benefit	$ 663	$ 578	$ 474	$ 711	$ 970	$ 1,373	$ 1,653	$ 1,059
Average Final Average Salary	22,101	29,518	26,928	28,637	30,998	34,818	35,868	31,509
Number of Active Retirants	771	697	6,429	6,929	6,485	7,204	8,598	37,113
Period 10/1/01 to 9/30/02								
Average Monthly Benefit	$ 670	$ 542	$ 491	$ 733	$ 1,007	$ 1,460	$ 1,789	$ 1,149
Average Final Average Salary	18,504	31,089	27,935	29,554	32,211	36,772	38,742	33,313
Number of Active Retirants	827	626	6,505	6,962	6,710	7,985	10,051	39,666
Period 10/1/02 to 9/30/03								
Average Monthly Benefit	$ 731	$ 559	$ 510	$ 758	$ 1,074	$ 1,573	$ 1,990	$ 1,298
Average Final Average Salary	23,640	29,738	28,338	29,985	33,205	39,023	42,071	35,175
Number of Active Retirants	1,056	653	6,632	7,036	7,221	9,889	13,004	45,491
Period 10/1/03 to 9/30/04								
Average Monthly Benefit	$ 475	$ 429	$ 528	$ 783	$ 1,112	$ 1,618	$ 2,036	$ 1,332
Average Final Average Salary	6,315	34,463	29,897	31,520	34,992	40,396	43,751	36,939
Number of Active Retirants	687	454	6,842	7,262	7,287	9,951	13,136	45,619
Period 10/1/04 to 9/30/05								
Average Monthly Benefit	$ 491	$ 437	$ 545	$ 807	$ 1,136	$ 1,650	$ 2,077	$ 1,360
Average Final Average Salary	5,754	34,264	29,838	31,806	34,749	40,329	43,302	36,774
Number of Active Retirants	712	453	6,850	7,272	7,303	10,035	13,176	45,801

Source: The Segal Company

Schedule of Average Benefit Payments - Health

September 30, 2005

Payment Periods	Credited Service (Years)							
	0-5	5-10	10-15	15-20	20-25	25-30	30+	Total
Period 10/1/04 to 9/30/05								
Average Monthly Benefit	$ 303	$ 447	$ 568	$ 837	$ 1,169	$ 1,665	$ 2,097	$ 1,403
Average Final Average Salary	24,519	32,338	31,463	33,062	36,386	41,099	44,724	38,580
Number of Active Retirants	139	625	5,807	6,476	6,787	9,409	12,064	41,307*

*Participating member totals displayed in this schedule and the information presented in Note 1 of this report may differ. These variances are the result of a mid-year data conversion.

Schedule of Average Benefit Payments - Dental

September 30, 2005

Payment Periods	Credited Service (Years)							
	0-5	5-10	10-15	15-20	20-25	25-30	30+	Total
Period 10/1/04 to 9/30/05								
Average Monthly Benefit	$ 306	$ 452	$ 571	$ 843	$ 1,175	$ 1,673	$ 2,107	$ 1,412
Average Final Average Salary	25,022	32,929	31,707	33,355	36,623	41,323	44,940	38,843
Number of Active Retirants	139	623	5,782	6,413	6,732	9,378	12,098	41,165*

*Participating member totals displayed in this schedule and the information presented in Note 1 of this report may differ. These variances are the result of a mid-year data conversion.

Schedule of Average Benefit Payments - Vision

September 30, 2005

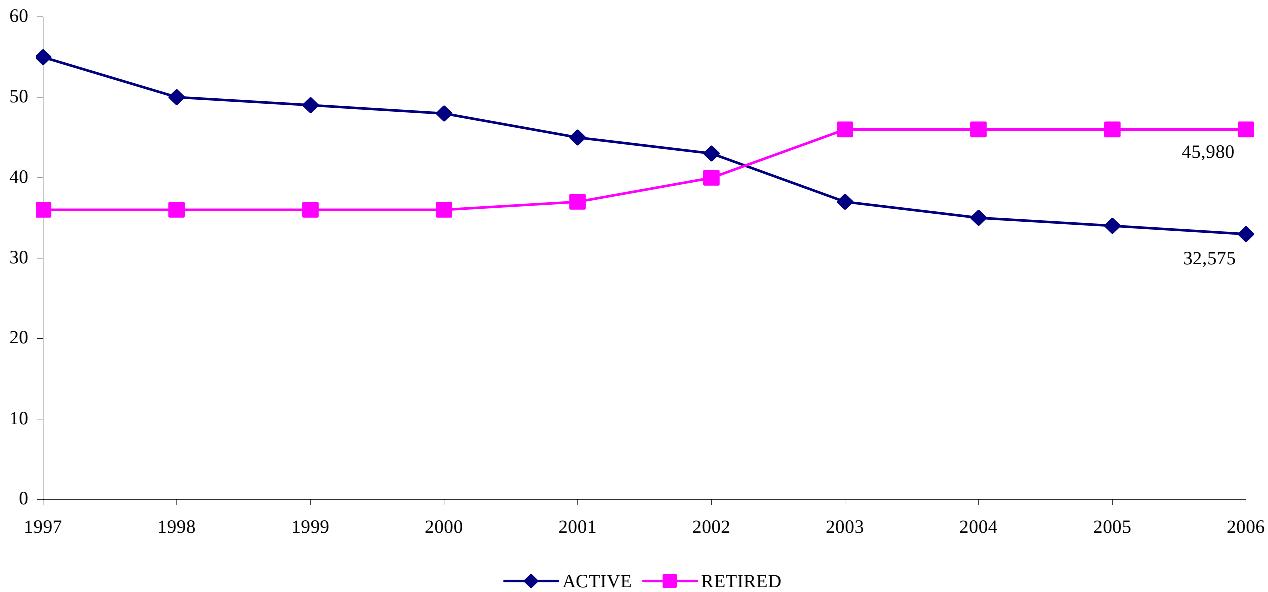
Payment Periods	Credited Service (Years)							
	0-5	5-10	10-15	15-20	20-25	25-30	30+	Total
Period 10/1/04 to 9/30/05								
Average Monthly Benefit	$ 308	$ 449	$ 570	$ 841	$ 1,174	$ 1,670	$ 2,106	$ 1,409
Average Final Average Salary	24,976	32,829	31,607	33,272	36,587	41,240	44,911	38,774
Number of Active Retirants	131	627	5,809	6,449	6,752	9,410	12,095	41,273*

*Participating member totals displayed in this schedule and the information presented in Note 1 of this report may differ. These variances are the result of a mid-year data conversion.

STATISTICAL SECTION

Ten Year History of Membership

Fiscal Year Ended September 30



Source: The Segal Company

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The report may be viewed on-line at: www.michigan.gov/ors