

1995

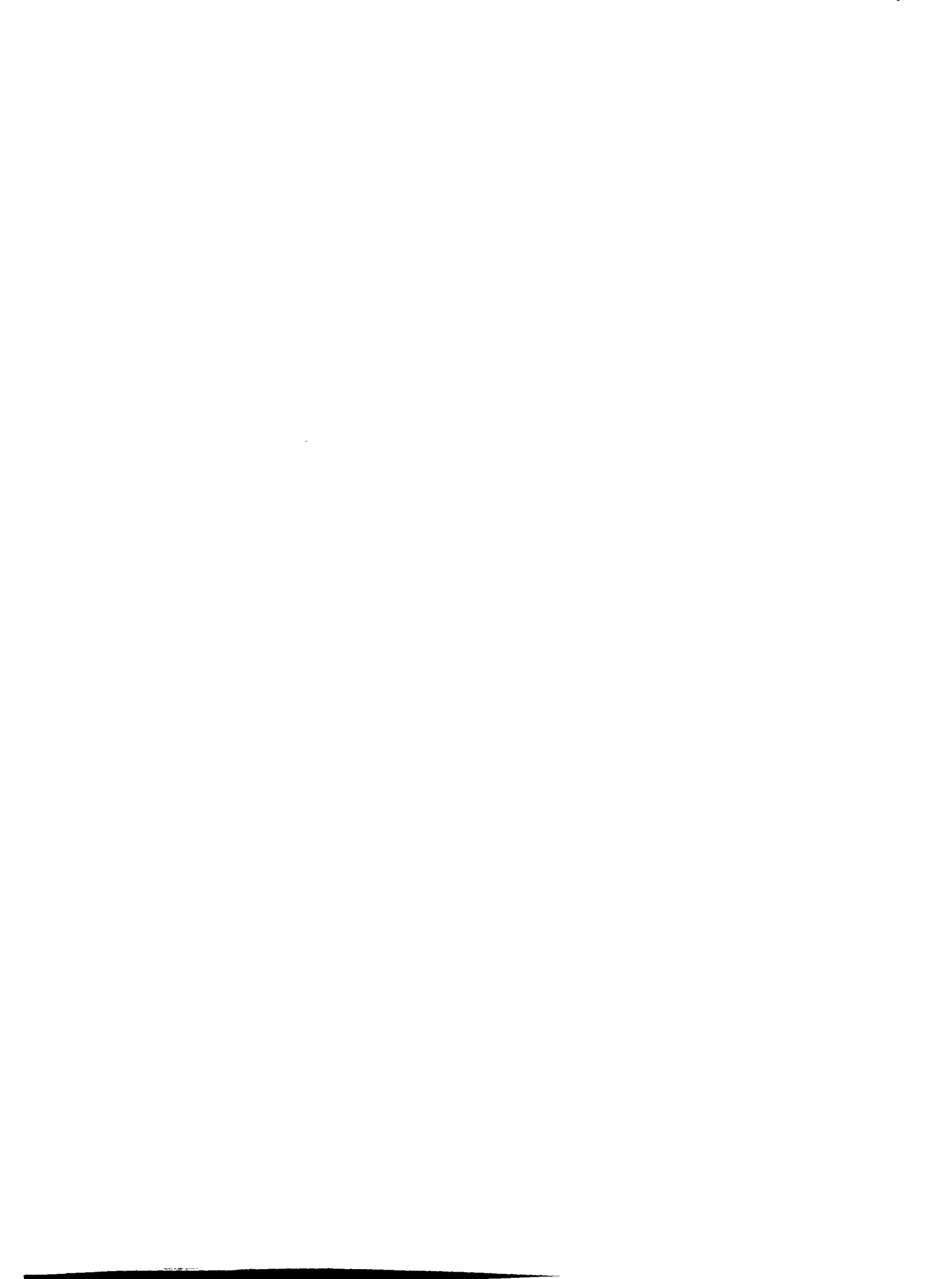
ANNUAL FINANCIAL REPORT

State Employees' Retirement System

COMMONWEALTH of PENNSYLVANIA

*Including the Report of Independent Accountants on Financial Statements
for the years ended December 31, 1995 and 1994*

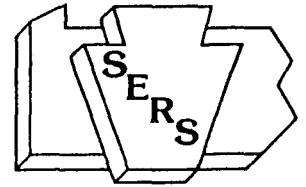






COMMONWEALTH OF PENNSYLVANIA
STATE EMPLOYEES' RETIREMENT BOARD

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NICHOLAS J. MAIALE
CHAIRMAN

June 1996

Honorable Tom Ridge, Governor
Commonwealth of Pennsylvania

Members, Pennsylvania General Assembly
Members, Pennsylvania State Employees' Retirement System

Dear Governor Ridge, Legislators and Members:

The Board of Trustees of the Pennsylvania State Employees' Retirement System (SERS) is pleased to present our *Annual Financial Report* on the SERS Fund for calendar year 1995.

As chairman of the SERS Board, I am especially pleased to note that the Fund had a 25.3% total investment rate of return in 1995 and a total market value of \$16.2 billion as of December 31, 1995. By comparison, the Fund's annualized investment rate of return for the past five years was 13.0%, and the annualized investment rate of return for the past 10 years was 11.4%.

These substantial returns have enabled SERS to maintain fully-funded status since 1992. They also validate the Board's adherence to two key principles:

- prudent management of fund assets, and
- ensuring payment of benefits promised by the Commonwealth to SERS retirees and beneficiaries.

Rest assured that the SERS Board, staff and I will continue to pursue prudent investment strategies to assure the solvency of the Fund and the quality of pension-related services to all SERS members.

Sincerely,

Nicholas J. Maiale
SERS Board Chairman

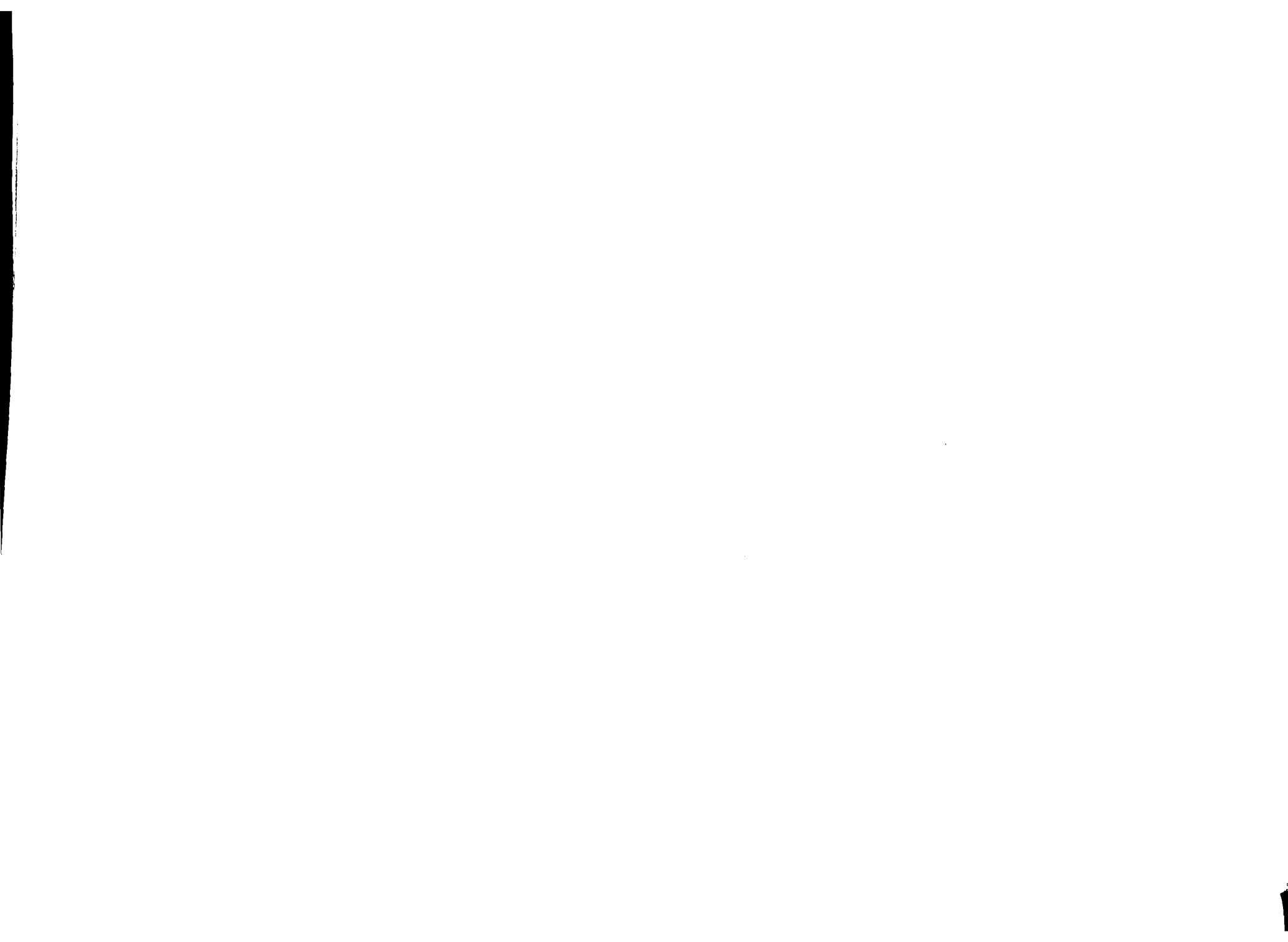


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K. Paul Muench

Budget Analyst

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Financial Consultant

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Former State Legislator

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RogersCasey & Associates
General Consultant

Cambridge Associates
*Venture Capital and Alternative Investments
Consultant*

The Townsend Group
Real Estate Consultant

Hamilton Lane
Specialty Consultant

General Service Providers

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Actuary

State Street Bank
*Agent Bank and
Trust Accounting Services*

Coopers & Lybrand L.L.P.
Independent Auditor

Mission Statement

I. Plan Administration: To administer the retirement benefits plan for state employes and elected officials in accordance with Pennsylvania statutes;

II. Member Services: To provide effective services to all active and retired members;

III. Management of Retirement Fund Assets: To accumulate, manage and disburse the retirement Fund assets in accordance with fiduciary standards and at a reasonable cost to Commonwealth taxpayers;

IV. Investment Policy: To maximize investment returns while exercising a prudent person investment policy.

Investment Policy

The State Employees' Retirement Board adopted a formal Statement of Investment Policy in 1979. It has been revised periodically, principally to reflect and incorporate legislative changes governing investments. The purpose of the statement is to formalize the Board's investment objectives, policies, and procedures, to establish guidelines for the investment of Fund assets, and to define the duties and responsibilities of the various entities involved in the investment process. The major elements of the statement are:

- As fiduciaries, the Board will exercise that degree of judgment, skill, and care under the circumstances then prevailing which persons of prudence, discretion, and intelligence, who are familiar with such matters, exercise in the management of their own affairs in investment matters;
- The Fund's overall investment objective is to provide a total rate of return, over full economic cycles, which exceeds the return of a fully diversified market portfolio within each asset class. The Board seeks to meet this objective within acceptable risk parameters through adherence to a policy of diversification of investments by type, industry, quality, and geographic location;
- The Board employs an investment staff and also contracts with investment advisors and consultants to provide expert, professional judgment in all investment decisions;
- An annual Investment Plan is prepared to control the allocation of funds during the year among investment advisors and categories of assets;
- Guidelines are established for each category of assets used by the Fund's investment advisors to provide a framework for monitoring quality, diversification, and liquidity; and
- Where investment characteristics, including yield, risk, and liquidity, are equivalent, the Board's policy favors investments which have a positive impact on the economy of Pennsylvania.

Investment Objectives

To assure an adequate accumulation of reserves in the Fund at the least cost to the citizens of the Commonwealth and to provide some protection against the erosion of principal by inflation, the long-term investment objectives of the Fund, are:

- Achieve and maintain the State Employees' Retirement Fund in excess of Accrued Benefit Liability;
- Over the long run, achieve a positive real total rate of return (with inflation measured by the GDP Implicit Price Deflator);
- Over the long run, achieve an absolute total rate of return not less than the actuarial investment return assumption;
- Achieve in Domestic Stocks a total return that exceeds the total return of the Wilshire 5000 Index;
- Achieve in International Stocks a total return that exceeds the total return of the SERS Custom International Stock Index;
- Achieve in the Fixed Income asset class a total return that exceeds the total return of the SERS Fixed Income Custom Index;
- Achieve in the Equity Real Estate asset class a total return that exceeds the total return of the NCREIF Index;
- Achieve in the Cash asset class a total return that exceeds the total return on U.S. Treasury Bills (90 days);
- Achieve in the Venture Capital asset class a total return that exceeds either the Venture Economics' relevant Vintage Year Median Returns or relevant returns furnished for benchmark purposes by SERS's Venture Capital/Alternative Investments consultant;
- Achieve in the Alternative Investments asset class a total return that exceeds either market returns for similar types of alternative investments or relevant returns furnished for benchmark purposes by SERS's Venture Capital/Alternative Investments consultant.

Total return includes income and both realized and unrealized gains and losses and is computed on market value. The Board seeks to meet these objectives within acceptable risk parameters through adherence to a policy of diversification of investments by type, industry, investment manager style, and geographic location.

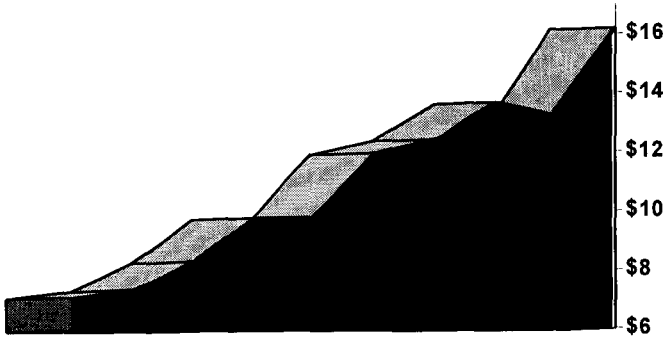


SECTION 1

Investment Program Overview
and
Summary of Asset Classes

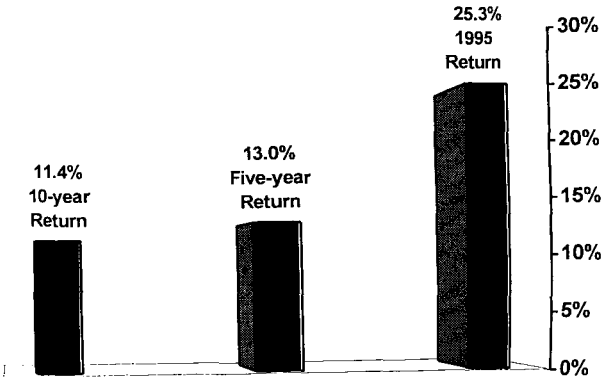
Investment Highlights

The unaudited market value* of the State Employees' Retirement System (SERS) investments, including accruals, was \$16,185.1 million as of December 31, 1995. This represents an increase of \$2,962.2 million from the \$13,222.9 million market value as of December 31, 1994. The increase was due to favorable investment returns in 1995 and takes into account the difference between \$586.2 million in employer and employee contributions and \$879.7 million paid out for benefits and refunds to participants. Based on the market value of assets as of September 30, 1995, the SERS Fund is the 24th largest public pension fund in the nation and ranks 39th among public and corporate pension funds.**



SERS Fund growth 1986 through 1995 (\$ in billions)

For the year ended December 31, 1995, SERS realized a +25.3% total investment rate of return after fees. While such a large one-year return is very gratifying, as a long-term investor with long-term liabilities, the Fund is most concerned with long-term performance. SERS's annualized five-year investment rate of return was +13.0% after fees, and the annualized 10-year investment rate of return was +11.4% after fees.



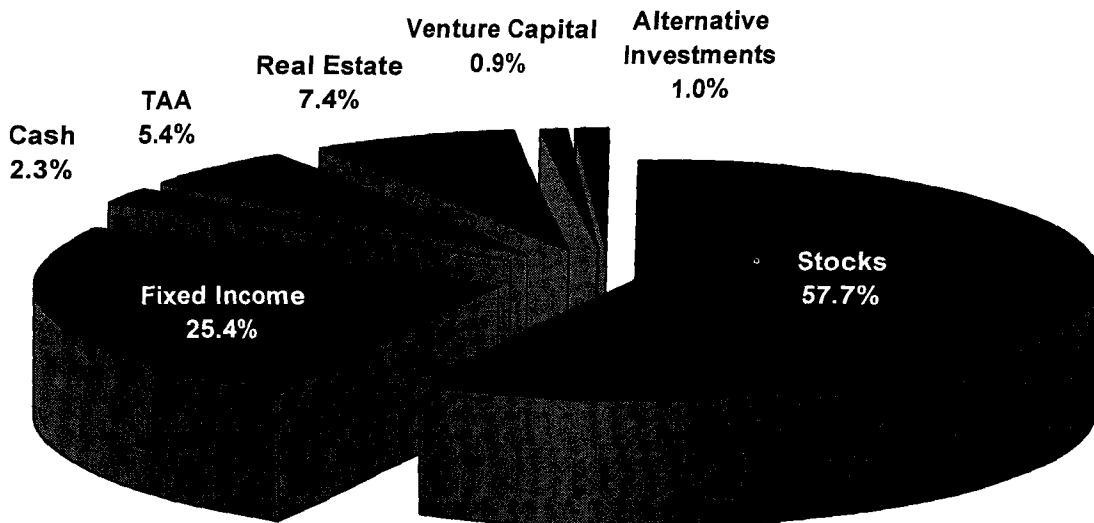
SERS Fund return over the last 10-year, five-year and one-year periods

*The investment portion of this report is based on unaudited, end-of-1995 figures. Section 4 of the report provides audited financial statements that became available in mid-1996. **Source: Pensions & Investments magazine, January 22, 1996.

Investment Program Summary

SERS's assets are administered by the SERS Board of Trustees. The Board has adopted an Investment Policy that incorporates the provisions of Pennsylvania's Retirement Code, which governs the investment of SERS's assets. The policy provides investment objectives and guidelines. An Investment Plan is reviewed and updated annually for strategic asset allocation purposes, as well as for diversification needs within each asset class.

SERS invests in seven major asset classes and uses external investment advisors with various investment styles as a method to ensure overall Fund diversification. As of December 31, 1995, SERS's asset class allocation was as follows: 57.7% stocks; 25.4% fixed income; 2.3% cash; 5.4% tactical asset allocation (TAA); 7.4% real estate; 0.9% venture capital; and 1.0% alternative investments.



SERS Fund asset allocation as of December 31, 1995, by asset class and percentage

Asset allocation is perhaps the most important investment decision of the Fund, accounting for as much as 90% of the Fund's return performance. Asset allocation policies have a long-term focus and may take several years to implement fully.

**Market value of SERS Fund asset classes and long-term target allocation as of December 31, 1995
(\$ in millions)**

Asset Class	Market Value	Long-Term Target Allocation
Domestic Stocks	\$7,502.4	46.4%
International Stocks	1,821.4	11.3%
Fixed Income	4,109.4	25.4%
Cash	364.5	2.3%
Tactical Asset Allocation	875.4	5.4%
Real Estate	1,193.0	7.4%
Venture Capital	152.0	0.9%
Alternative Investments	166.9	1.0%
Total	\$16,185.1	100.0%

Numbers may not add due to rounding.

Investment Advisors and Portfolios

As of December 31, 1995, SERS had retained the services of 84 external investment advisors, including:

- 12 domestic stock investment advisors
- 6 international stock investment advisors
- 10 fixed income investment advisors
- 2 cash investment advisors
- 1 tactical asset allocation investment advisor
- 15 real estate investment advisors
- 22 venture capital limited partnership managing general partners
- 16 alternative investment limited partnership managing general partners

In addition, five domestic stock advisors, seven international stock advisors and one fixed income advisor were approved by the Board but not yet funded at the end of 1995. As of December 31, 1995, SERS's 84 external investment advisors managed 108 investment portfolios/accounts, including:

- 16 domestic stock portfolios
- 7 international stock portfolios
- 11 fixed income portfolios
- 3 cash portfolios
- 1 tactical asset allocation portfolio
- 23 real estate portfolios
- 28 venture capital limited partnership interests
- 19 alternative investment limited partnerships

In addition, five domestic stock portfolios, eight international stock portfolios, one fixed income portfolio and one alternative investment partnership were approved by the Board but not yet funded at the end of 1995. Several investment advisors manage multiple portfolios for SERS.

Pennsylvania State Employees' Retirement System

Asset Allocation as of December 31, 1995

Total Fund Summary	<u>Market Value (\$ in millions)</u>	<u>% of Total Fund</u>
Domestic Stocks	\$7,502.4	46.4%
International Stocks	1,821.4	11.3%
Fixed Income	4,109.4	25.4%
Cash	364.5	2.3%
Tactical Asset Allocation	875.4	5.4%
Real Estate	1,193.0	7.4%
Venture Capital	152.0	0.9%
Alternative Investments	166.9	1.0%
Total Fund	\$16,185.1	100.0%

Domestic Stocks	<u>(\$ in millions)</u> <u>Market Value</u>	<u>% of Domestic</u> <u>Stocks</u>	<u>% of Total</u> <u>Stocks</u>	<u>% of Total</u> <u>Fund</u>
<u>Passively Managed Portfolios</u>				
BZW Barclays - Equity Index (S&P 500)	\$3,457.0	46.1%	37.1%	21.4%
BZW Barclays - Equity Value Fund	348.3	4.6%	3.7%	2.2%
BZW Barclays - Extended Equity Market Fund	956.2	12.7%	10.3%	5.9%
<i>Domestic Passive Stocks Total</i>	<u>\$4,761.5</u>	<u>63.5%</u>	<u>51.1%</u>	<u>29.4%</u>
<u>Actively Managed Portfolios</u>				
Dietche & Field Advisors, Inc.	\$82.3	1.1%	0.9%	0.5%
Emerald Advisers, Inc. - PA	54.2	0.7%	0.6%	0.3%
Iridian Asset Management	204.9	2.7%	2.2%	1.3%
Mellon Equity Associates - PA	53.7	0.7%	0.6%	0.3%
Mellon Equity Associates - Special Equity	523.3	7.0%	5.6%	3.2%
Miller, Anderson & Sherrerd	368.5	4.9%	4.0%	2.3%
Neuberger & Berman	76.7	1.0%	0.8%	0.5%
Pilgrim Baxter & Associates	346.0	4.6%	3.7%	2.1%
Provident Investment Counsel	447.4	6.0%	4.8%	2.8%
Provident Investment Counsel - Stellar Fund	79.2	1.1%	0.8%	0.5%
Sturdivant & Co., Inc.	30.8	0.4%	0.3%	0.2%
Trinity Investment Management	463.0	6.2%	5.0%	2.9%
Zevenbergen Capital	10.9	0.1%	0.1%	0.1%
<i>Domestic Active Stocks Total</i>	<u>\$2,740.9</u>	<u>36.5%</u>	<u>29.4%</u>	<u>16.9%</u>
<i>Domestic Stocks Total</i>	<u>\$7,502.4</u>	<u>100.0%</u>	<u>80.5%</u>	<u>46.4%</u>

International Stocks		<u>% of Int'l</u> <u>Stocks</u>		
<u>Passively Managed Portfolios</u>				
BZW Barclays - Europe Acct.	\$220.7	12.1%	2.4%	1.4%
BZW Barclays - Restructuring Acct.	27.2	1.5%	0.3%	0.2%
<i>International Passive Stocks Total</i>	<u>\$247.9</u>	<u>13.6%</u>	<u>2.7%</u>	<u>1.5%</u>
<u>Actively Managed Portfolios</u>				
BEA Associates - core	\$340.2	18.7%	3.6%	2.1%
Dunedin Fund Managers - small cap	268.2	14.7%	2.9%	1.7%
Miller, Anderson & Sherrerd - core	442.2	24.3%	4.7%	2.7%
Seligman Henderson Co. - small cap	139.7	7.7%	1.5%	0.9%
Templeton Investment Counsel - core	383.1	21.0%	4.1%	2.4%
<i>International Active Stocks Total</i>	<u>\$1,573.5</u>	<u>86.4%</u>	<u>16.9%</u>	<u>9.7%</u>
<i>International Stocks Total</i>	<u>\$1,821.4</u>	<u>100.0%</u>	<u>19.5%</u>	<u>11.3%</u>
<i>Domestic and International Stocks Total</i>	<u>\$9,323.9</u>		<u>100.0%</u>	<u>57.6%</u>

Asset Allocation as of December 31, 1995 (continued)

Fixed Income	(\$ in millions) Market Value	% of Total Fixed Income	% of Total Fund
<u>Passively Managed Core Portfolios</u>			
Mellon Bond Associates	\$898.9	21.9%	5.6%
<u>Actively Managed Core Portfolios</u>			
P. G. Corbin	\$9.5	0.2%	0.1%
Miller, Anderson & Sherrerd	1,426.8	34.7%	8.8%
J. P. Morgan	506.7	12.3%	3.1%
Smith Graham & Co.	9.1	0.2%	0.1%
<i>Active Core Fixed Income Total</i>	<u>\$1,952.1</u>	<u>47.5%</u>	<u>12.1%</u>
<i>Core Fixed Income Total</i>	<u>\$2,850.9</u>	<u>69.4%</u>	<u>17.6%</u>
<u>Actively Managed Specialty Portfolios</u>			
Cigna Investments	\$1.6	0.0%	0.0%
John Hancock	148.2	3.6%	0.9%
W. R. Huff Asset Management	632.5	15.4%	3.9%
Legg Mason Real Estate Advisors	458.6	11.2%	2.8%
Trust Company of the West	17.6	0.4%	0.1%
<i>Active Specialty Fixed Income Total</i>	<u>\$1,258.5</u>	<u>30.6%</u>	<u>7.8%</u>
<i>Fixed Income Total</i>	<u>\$4,109.4</u>	<u>100.0%</u>	<u>25.4%</u>
Cash		% of Total Cash	
Payden & Rygel	\$98.8	27.1%	0.6%
PA State Treasury (Separate Acct. + STIP)*	265.7	72.9%	1.6%
<i>Cash Total</i>	<u>\$364.5</u>	<u>100.0%</u>	<u>2.3%</u>
Tactical Asset Allocation		Allocation (Stocks / Bonds / Cash)	
BZW Barclays - Enhanced 70/30 U.S. TAA	<u>\$875.4</u>	70%/10%/20%	5.4%

Continued on page 6

Pennsylvania State Employees' Retirement System

Asset Allocation as of December 31, 1995 (continued)

Real Estate	(\$ in millions) <u>Market Value</u>	<u>% of Total Real Estate</u>	<u>% of Total Fund</u>
<u>Separate Account Portfolios</u>			
Forest Investment Associates	\$37.0	3.1%	0.2%
Heitman/JMB	456.3	38.3%	2.8%
LaSalle Partners	65.5	5.5%	0.4%
Lowe Enterprises	132.2	11.1%	0.8%
RAI Advisers	41.1	3.4%	0.3%
<i>Separate Account Portfolios Total</i>	\$732.2	61.4%	4.5%
<u>Pooled Fund Portfolios</u>			
Aetna - 4 pooled funds	\$83.5	7.0%	0.5%
Alex Brown	11.4	1.0%	0.1%
Copley CIIF-II	12.5	1.1%	0.1%
Corporate Property Investors	112.7	9.4%	0.7%
Goldman Sachs - Whitehall V & VI	28.7	2.4%	0.2%
Goldman Sachs - Whitehall V-S & VI-S	6.8	0.6%	0.0%
John Hancock	12.5	1.1%	0.1%
Heitman - California Land Venture	1.3	0.1%	0.0%
JMB Group Trust III	37.0	3.1%	0.2%
Metric Apartment Fund - 2 pooled funds	46.9	3.9%	0.3%
PSI III	17.7	1.5%	0.1%
Prudential - 2 pooled funds	0.1	0.0%	0.0%
Sentinel Corporation	37.4	3.1%	0.2%
Trust Company of the West - Fund VI	52.2	4.4%	0.3%
<i>Pooled Fund Portfolios Total</i>	\$460.8	38.6%	2.8%
<i>Real Estate Total</i>	\$1,193.0	100.0%	7.4%
<hr/>			
Venture Capital**	<u>% of Total Venture Capital</u>		
APA/Fostin - PA VC Fund & Fund II	\$26.5	17.4%	0.2%
Advent VII	16.4	10.8%	0.1%
Bachow III	7.3	4.8%	0.0%
CEO Venture Fund S & II	8.8	5.8%	0.1%
Edison III	10.9	7.2%	0.1%
Fairview Capital	0.9	0.6%	0.0%
Fostin Capital I & II	7.4	4.9%	0.0%
Grotech Pennsylvania III & IV	10.5	6.9%	0.1%
Healthcare Ventures III	14.8	9.7%	0.1%
Keystone II & IV	10.8	7.1%	0.1%
NEA VI	15.7	10.3%	0.1%
NEPA Venture I & II	6.9	4.5%	0.0%
PNC Venture Group I	1.4	0.9%	0.0%
Pittsburgh Seed Fund	0.4	0.3%	0.0%
Point Venture Partners	0.5	0.3%	0.0%
Sprout VII	3.4	2.2%	0.0%
Stock Distributions	1.1	0.7%	0.0%
Summit Ventures IV	2.4	1.6%	0.0%
TDH-II Limited	3.5	2.3%	0.0%
Weston Presidio	2.0	1.3%	0.0%
Zero Stage Capital II	0.6	0.4%	0.0%
<i>Venture Capital Total</i>	\$152.0	100.0%	0.9%

Asset Allocation as of December 31, 1995 (continued)

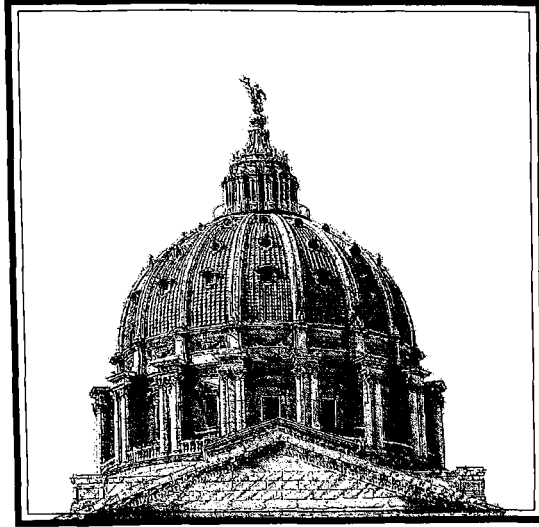
Alternative Investments**	(\$ in millions) Market Value	% of Total Alter. Inv.	% of Total Fund
APAX Partners - 2 European funds	\$7.1	4.2%	0.0%
Blackstone II	9.3	5.6%	0.1%
Brentwood Associates Buyout Fund	15.7	9.4%	0.1%
Charterhouse II	20.8	12.4%	0.1%
Code, Hennessy & Simmons I & II	14.7	8.8%	0.1%
Hellman & Friedman II & III	32.1	19.2%	0.2%
Kelso V	16.3	9.8%	0.1%
Landmark IV	2.9	1.7%	0.0%
Madison Dearborn	6.2	3.7%	0.0%
Murphy & Fauver	3.9	2.3%	0.0%
RR & Z Pennsylvania Fund #1	0.2	0.1%	0.0%
Schroder Ventures UK III	5.7	3.4%	0.0%
Trust Company of the West - Fund V	32.1	19.2%	0.2%
<i>Alternative Investments Total</i>	\$166.9	100.0%	1.0%

Numbers may not add due to rounding.

*Pennsylvania State Treasury values for the Short Term Investment Pool (STIP) portion are at cost and do not reflect cash maintained at Treasury by SERS investment advisors. Including SERS advisors' cash, the actual Treasury STIP balance = \$504.7 million.

**Venture capital and alternative investment market values are estimates.





Summary *of* Asset Classes

Summary of *Domestic* Stock Investments

Domestic and international stocks comprise the stock asset class. SERS's investment plan diversifies stock investments and balances stock management styles. SERS contracts with external investment advisors to manage portfolios.

Policy

Stock investments are employed by the Fund primarily because their expected large return premiums versus inflation will, if realized, help preserve and enhance the real value of the Fund over long periods of time. The stock asset class is to be managed on a total return basis. Stock investments shall emphasize, but not be limited to, publicly traded securities that provide SERS with an equity interest in private sector concerns (e.g., common stock, preferred stock, convertible preferred stock, convertible bonds, etc.).

SERS's 1995 Investment Plan targeted an eventual allocation of 36.5% of assets to domestic stocks, with a targeted investment of 70.0% of domestic stocks in large capitalization stocks and 30.0% in medium/small capitalization stocks. The plan also provided for a balance in value and growth investment styles. The 1995 plan targeted 55.1% of domestic stocks to be indexed.

Market Value

Domestic stocks had a \$7,502.4 million market value, 46.4% of the total Fund's \$16,185.1 million market value, on December 31, 1995.

Number of Investment Advisors

SERS had contracts with 12 external investment advisors to manage domestic stock portfolios. Five additional investment advisors for this area were also approved by the SERS Board.

Number of Investment Portfolios

SERS had 16 domestic stock portfolios managed by the 12 external investment advisors. Five additional portfolios for this area were also approved by the Board.

Types of Investment Portfolios

As of December 31, 1995, 68.3% of SERS's domestic stock allocation was in large capitalization stock strategies, and 31.7% was in medium/small capitalization stock strategies. The portfolios within the domestic stock area can be classified by investment style: 16.1% value; 17.4% growth; and 66.5% core. SERS had 13 actively managed portfolios (36.5% of domestic stocks) and three passively managed index portfolios (63.5% of domestic stocks). The active managers search out superior investment opportunities. The passively managed portfolios provide broad core diversification and are designed to track the performance of the market at a low cost.

1995 Annual Financial Report

Domestic Stock Investment Advisor	Investment Style	*Market Value of Portfolio as of December 31, 1995 (\$ millions)
BZW Barclays Global Investors		
● Equity Index Fund P (S&P 500)	large cap stocks - indexed core	\$3,457.0
● Equity Value Fund	large cap value stocks - indexed	348.3
● Extended Equity Market Fund (Wilshire 4500)	medium/small cap stocks - indexed core	956.2
Dietche & Field Advisors	medium/small cap value stocks	82.3
Emerald Advisers	PA growth stocks	54.2
Fidelity Management Trust Co.	S&P 500, risk controlled	**
Iridian Asset Management	medium cap value stocks	204.9
Loomis, Sayles & Co.	large cap value stocks	**
Lord, Abbett & Co.	large cap value stocks	**
Mackay Shields	large cap value stocks	**
Mellon Equity Associates		
● PA Equity Portfolio	PA stocks	53.7
● Special Equity	medium/small cap stocks	523.3
Miller, Anderson & Sherrerd	large cap growth stocks	368.5
J.P. Morgan Investment Management	S&P 500, risk controlled	**
Neuberger & Berman	medium/small cap value stocks	76.7
Pilgrim, Baxter & Associates	medium/small cap growth stocks	346.0
Provident Investment Counsel (PIC)	large cap growth stocks	447.4
● PIC Stellar Fund	small cap growth stocks	79.2
Sturdivant & Co.	large cap value stocks	30.8
Trinity Investment Management	large cap value stocks	463.0
Zevenbergen Capital	large cap growth stocks	10.9
Total		\$7,502.4

**Includes stocks and cash which the manager had available for investment. **Market values not listed for managers hired but not yet funded at the end of 1995. Numbers may not add due to rounding.*

Summary of *International* Stock Investments

International and domestic stocks comprise the stock asset class. SERS's investment plan diversifies stock investments and balances stock management styles. SERS contracts with external investment advisors to manage portfolios.

Policy

Stock investments are employed by the Fund primarily because their expected large return premiums versus inflation will, if realized, help preserve and enhance the real value of the Fund over long periods of time. The stock asset class is to be managed on a total return basis. SERS's 1995 Investment Plan targeted an eventual allocation of 20.0% of assets to international stocks, with a targeted investment of 80.0% of international stock to large capitalization stock strategies and 20.0% to medium/small capitalization stock strategies.

Market Value

International stocks had a \$1,821.4 million market value, 11.3% of the total Fund's \$16,185.1 million market value, on December 31, 1995.

Number of Investment Advisors

SERS had contracts with six external investment advisors to manage international stock portfolios. Seven additional investment advisors for this area were approved by the Board.

Number of Investment Portfolios

SERS had seven international stock portfolios managed by the six external investment advisors. Eight additional portfolios for this area were approved by the Board.

Types of Investment Portfolios

As of December 31, 1995, 77.6% of SERS's international stock allocation was in large capitalization stock strategies, and 22.4% was in medium/small capitalization stock strategies. SERS had five actively managed international portfolios and one Europe index portfolio.

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<i>International Stock Investment Advisor</i>	<i>Investment Style</i>	<i>*Market Value of Portfolio as of December 31, 1995 (\$ millions)</i>
BEA Associates	international stocks - core	\$340.2
BZW Barclays Global Investors		
● Australia and New Zealand	Australia and New Zealand stocks - indexed	**
● Europe	Europe stocks - indexed	220.7
● Restructuring Account	Europe and Pacific Basin stocks	27.2
Dunedin Fund Managers	international medium/small cap stocks	268.2
GAM International Management	Pacific Basin ex Japan stocks	**
Marathon Asset Management	Europe stocks	**
Mercury Asset Management	international medium/small cap stock	**
Miller, Anderson & Sherrerd	international stocks - core	442.2
J.P. Morgan Investment Management	Japan stocks	**
Pictet International Management	international medium/small cap stock	**
Scottish Widows Investment Management	Europe stocks	**
Seligman Henderson	international medium/small cap stock	139.7
TCW Asset Management	Asia ex Japan stocks	**
Templeton Investment Counsel	international stocks - core	383.1
Total		\$1,821.4

*Includes stock and cash that the manager had available for investment. **Market values not listed for managers hired but not yet funded at the end of 1995. Numbers may not add due to rounding.

Summary of Fixed Income Investments

SERS's Investment Plan diversifies fixed income investments and balances fixed income management styles. SERS's practice is to contract with external investment advisors to manage portfolios.

Policy

Fixed income investments are employed by the Fund primarily because they serve as a hedge against disinflation and/or deflation, their general ability to produce current income in the form of periodic interest payments, and because such investments help diversify the overall Fund. The fixed income asset class is to be managed on a total return basis. SERS's 1995 Investment Plan targeted an eventual allocation of 22.5% of assets to the fixed income asset class. Of this amount, 75.0% was targeted to active strategies, and 25.0% to passive strategies. The asset class is further classified according to core and specialty strategies, with 75.0% targeted to the core segment and 25.0% to the specialty segment. Specialty strategies include:

- whole-loan mortgages;
- high yield/special credits; and
- private placements.

Market Value

Fixed income had a \$4,109.4 million market value, 25.4% of the total Fund's \$16,185.1 million market value, on December 31, 1995.

Number of Investment Advisors

SERS had contracts with 10 external investment advisors to manage portfolios within the fixed income asset class as of December 31, 1995. One additional investment advisor for this area was also approved by the SERS Board of Trustees.

Number of Investment Portfolios

SERS had a total of 11 portfolios within the fixed income asset class. One additional portfolio for this area was also approved by the SERS Board of Trustees.

Types of Investment Portfolios

The fixed income asset class is divided into core and specialty segments. Core portfolios utilize a broad array of fixed income securities. Specialty portfolios focus on well-defined sectors and opportunistic strategies within the fixed income market.

Core: SERS had four actively managed core bond portfolios with a market value of \$1,952.1 million (47.5% of fixed income) and one passively managed core bond portfolio with a market value of \$898.9 million (21.9% of fixed income).

Specialty: SERS had one whole-loan mortgage portfolio with a market value of \$458.6 million (11.2% of fixed income), three high yield/special credits portfolios with a market value of \$651.7 million (15.8% of fixed income), and two private placement portfolios with a market value of \$148.2 million (3.6% of fixed income).

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<i>Fixed Income</i> Investment Advisor	Investment Style	*Market Value of Portfolio as of December 31, 1995 (\$ millions)
Core		
P.G. Corbin Asset Management	active domestic fixed income	\$9.5
Fischer Francis Trees & Watts	active international fixed income	**
Mellon Bond Associates	domestic - indexed	898.9
Miller, Anderson & Sherrerd	active domestic/global fixed income	1,426.8
J.P. Morgan Investment Management	active domestic fixed income	506.7
Smith Graham & Co.	active domestic fixed income	9.1
Specialty		
Cigna Investments	PA private placements	1.6
John Hancock Mutual Life Insurance Company	privately placed fixed income	148.2
W. R. Huff Asset Management	high yield bonds	632.5
Legg Mason Real Estate Advisors	residential and commercial mortgages	458.6
Trust Company of the West Special Credits Fund IIb	special credits	3.9
Trust Company of the West Special Credits Fund III	special credits	13.7
Total		\$4,109.4

*Includes securities and cash that the manager had available for investment. **Market value not listed for manager hired but not yet funded at the end of 1995. Numbers may not add due to rounding.

Summary of Cash Investments

SERS's Investment Plan diversifies cash investments and balances cash management styles. It is SERS's practice to contract with external investment advisors to manage portfolios.

Policy

Cash investments are employed by the Fund to provide for SERS's liquidity needs and to accumulate funds for future permanent investment. The cash asset class is to be managed on a total return basis, with the exception that temporary investments may alternatively be evaluated on a yield-to-maturity basis given their extremely short maturities. SERS's 1995 Investment Plan targeted an eventual allocation of 1.0% of assets to the cash asset class.

Market Value

Cash had a \$364.5 million market value, 2.3% of the total Fund's \$16,185.1 million market value as of December 31, 1995.

Number of Investment Advisors

SERS had a contract with one external investment advisor to manage a portfolio within the cash asset class. SERS also utilizes the Pennsylvania State Treasury Department to manage two cash accounts.

Number of Investment Portfolios

SERS had three portfolios within the cash asset class: one managed by the external investment advisor and two managed by the Pennsylvania State Treasury Department.

Types of Investment Portfolios

SERS had one actively managed, short-duration fixed income portfolio with a market value of \$98.8 million (27.1% of cash). On a combined basis, the two portfolios managed by the Pennsylvania State Treasury Department had a market value of \$265.7 million (72.9% of cash). Treasury also manages excess cash balances maintained by other SERS investment advisors in other asset classes. In the aggregate, Treasury managed \$504.7 million on behalf of SERS and SERS's external investment advisors as of December 31, 1995.

<i>Cash</i> Investment Advisor	<i>Investment Style</i>	<i>Market Value of Portfolios as of December 31, 1995 (\$ millions)*</i>
Payden & Rygel	Short duration fixed income	\$98.8
PA State Treasury Department		
• Separate Account	Short duration fixed income	101.2
• Short-Term Investment Pool**	Short term fixed income and money market instruments	164.5
Total		\$364.5

*Numbers may not add due to rounding. **Market value does not include cash maintained in the Short-Term Investment Pool by SERS's other external investment advisors.

Summary of *Tactical Asset Allocation* Investments

SERS's tactical asset allocation (TAA) asset class currently contains one investment strategy, the Enhanced 70/30 Normal U.S. Tactical Asset Allocation (Enhanced 70/30 TAA). The Enhanced 70/30 TAA strategy shifts assets among stocks, bonds and cash. It is SERS's practice to contract with external investment advisors to manage portfolios. SERS contracts with external investment advisor BZW Barclays Global Investors (BZW Barclays) to manage the portfolio.

Policy

SERS's 1995 Investment Plan targeted an eventual allocation of 5.0% of assets to the TAA asset class.

Market Value

SERS's investment in the BZW Barclays Enhanced 70/30 TAA Fund had a \$875.4 million market value, 5.4% of the total Fund's \$16,185.1 million market value, on December 31, 1995.

Number of Investment Advisors

SERS had a contract with one external investment advisor to manage a TAA portfolio as of December 31, 1995.

Number of Investment Portfolios

SERS had one TAA portfolio managed by the one external investment advisor.

Types of Investment Portfolios

The BZW Barclays Enhanced 70/30 TAA Fund is designed to offer an efficient, low cost means of seeking above-market returns from a portfolio diversified among the domestic stock, fixed income and cash markets. The Fund invests in three of BZW Barclays' collective funds. Proprietary technology is used to establish and adjust the optimal asset mix among these funds. The mix will vary as economic and capital market conditions change. Under equilibrium conditions, the Enhanced 70/30 TAA Fund will have 70.0% of assets invested in the Equity Index Fund, 30.0% of assets invested in the Long Term Income Fund, and 0.0% in the Cash Fund. As of December 31, 1995, the actual asset mix of the Fund was 70.0% stock, 10.0% bonds, and 20.0% cash.

Summary of Real Estate Investments

SERS's Investment Plan diversifies equity real estate investments and balances real estate management styles. In accordance with the plan, SERS contracts with external investment advisors to manage portfolios.

Policy

Equity real estate investments are generally long-term, illiquid investments that, due to their high correlation with inflation, provide an inflation hedge and diversification within the total portfolio due to their low correlation with stocks and bonds. It is expected that the long-term total return (income and appreciation) for real estate will fall between those of stocks and bonds. The equity real estate asset class is managed on a total return basis. SERS's 1995 Investment Plan targeted an eventual allocation of 10.0% of assets to the equity real estate asset class. Investments are made through pooled-fund investments and separate account portfolios where SERS owns the properties directly or with other co-investors. SERS's equity real estate portfolio guidelines provide for diversification by transaction structures, property types, geographic location, and development phase. Of SERS's equity real estate investments, 20.0% are located in Pennsylvania.

Market Value

Real estate had a \$1,193.0 million market value, 7.4% of the total Fund's \$16,185.1 million market value, on December 31, 1995.

Number of Investment Advisors

SERS had contracts with 15 external investment advisors to manage real estate portfolios as of December 31, 1995.

Number of Investment Portfolios

SERS had investments in 23 real estate portfolios managed by the 15 external investment advisors.

Types of Investment Portfolios

As of December 31, 1995, the composition of the real estate portfolio was as follows:

- 80% equity ownership, 20% equity-oriented mortgages;
- 38.6% pooled funds, 61.4% separate accounts;
- 20.0% office, 8.0% industrial, 38.0% retail, 22.0% residential, 6.0% hotel/motel, 6.0% other;
- 20.0% Pennsylvania, 25.0% East (excl. PA), 19.0% West, 18.0% South, 18.0% Midwest.

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<i>Real Estate</i> Investment Advisor	SERS Initial Funding	Property Type	Transaction Structure	Market Value of Portfolio as of December 31, 1995 (\$ in millions)*
Aetna				
● CERESA I	06-30-83	office, industrial	equity ownership	\$2.4
● PMSA	09-30-83	diversified	equity oriented mtgs.	40.0
● RESA	06-30-84	diversified	equity ownership	29.9
● Apartment Fund	12-31-86	residential	equity ownership	11.3
Copley CIIF-II	08-08-88	industrial, other	equity ownership	12.5
Corporate Property Investors	12-08-83	office, industrial retail	equity ownership	112.7
Forest Investment Assoc.	10-30-92	timber	equity ownership	37.0
Goldman Sachs				
● Whitehall V & VI	4/20/94	Opportunistic	equity and debt	28.7
● Whitehall V-S & VI-S	12/11/95	Opportunistic	equity and debt	6.8
John Hancock Apartment Fund	09-30-86	residential	equity ownership	12.5
Heitman/JMB				
● Separate account	12-28-87	office, industrial retail	equity ownership	456.3
● California Land Venture	12-07-89	land	equity ownership	1.3
● JMB Group Trust III	12-31-84	office, retail	equity ownership	37.0
LaSalle				
● Alex Brown Profile Fund	12-31-84	office, industrial retail, residential	equity ownership	11.4
● Separate Account	10-1-93	diversified	equity ownership	65.5
Lowe Enterprises	10/1/93	diversified	equity ownership	132.2
Metric				
● MIAF	09-05-89	residential	equity ownership	23.2
● MIAF II	12-07-92	residential	equity ownership	23.7
PSI III	08-16-88	industrial	equity ownership	17.7
Prudential				
● PRACE I	12-31-83	office, industrial	equity ownership	0.06
● PRACE II	12-31-84	industrial, residential	equity ownership	0.02
RAI Advisers	10/1/93	PA diversified	equity ownership	41.1
Sentinel Corp.	07-31-84	office, industrial retail, residential	equity ownership	37.4
TCW Fund VI	4/20/94	Opportunistic	equity and debt	52.2
Total				\$1,193.0

*Numbers may not add due to rounding.

Summary of *Venture Capital* Investments

Venture capital is the financing of young, relatively small, rapidly growing companies that do not have access to public equity or debt-oriented institutional funding. SERS invests capital as a limited partner in venture capital limited partnerships established for the purpose of investing in and managing venture capital companies.

Policy

SERS's 1995 Investment Plan targeted an eventual allocation of 2.0% of assets to the venture capital asset class.

History

Act 1984-95, effective in 1984, specified that SERS may invest up to 1.0% of Fund assets in venture capital by acquiring equity or debt and equity interests in a business that is expected to grow substantially in the future. Act 1991-23, effective in 1991, specified that SERS may invest up to 2.0% of the Fund in venture capital. Furthermore, Act 1994-29, effective in 1994, enabled SERS to invest according to "prudent person" standards, and further specified that an investment in venture capital by SERS may be made only if the investment is reasonably likely to enhance the general welfare of the Commonwealth and its citizens.

Market Value

SERS's venture capital investments had a \$152.0 million market value, 0.9% of the total Fund's \$16,185.1 million market value, on December 31, 1995. In addition, SERS had \$190.1 million in outstanding obligations to fund venture capital partnerships that represented 1.1% of the total Fund at December 31, 1995. Therefore, the combined market value of SERS's actual venture

capital investments and future obligations to fund such investments equaled \$342.1 million, or approximately 2.0% of the total Fund, as of December 31, 1995.

Number of Limited Partnerships

SERS has made commitments to 28 venture capital limited partnerships. As of December 31, 1995, SERS had paid in capital as a limited partner in 26 of those partnerships. Paid-in capital represents funds that have been drawn down by the venture capitalist and are readily available for investment.

Venture Capital Program

SERS's 28 venture capital limited partnerships are committed to include Pennsylvania-based companies as a part of their venture investment focus. The intent is to make venture capital investments in companies either headquartered in Pennsylvania or that provide employment for Pennsylvania citizens. As of December 31, 1995, SERS's venture capital limited partnerships had made approximately 35.0% of their investments in Pennsylvania-based companies since inception. In addition, venture capital managers backed by SERS have invested over \$129 million in Pennsylvania-based start-up companies since the SERS program began in 1985. SERS has committed \$380.5 million out of a total partnership capital pool (all investors in these funds) of \$2,695.8 million. Given that SERS effectively owns 14.0% of this pool, the sizable amount of capital invested in Pennsylvania-based companies indicates the effective use of leveraging additional sources of capital. A major component of the venture capital program is to diversify company investments across industries.

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As of December 31, 1995, the program was well diversified across the following industry categories:

29% computer related industries	26% health-care related industries	15% biotechnology
8% telecommunications	7% financial services	4% consumer products
3% industrial products	2% electronic products	2% restaurants
2% retailing	1% media services	1% others

The venture program's financing stage focus varies: 18 of the limited partnerships have a diversified financing stage focus; four are focused on middle- and later-stage financing; five are focused on seed and early-stage financing; and one intends to make diversified stage financing available to minority-owned enterprises.

Venture Capital Committed, Drawn and Distributed as of December 31, 1995

In the chart below, Capital Committed represents SERS's capital committed to a venture capital limited partnership; Capital Drawn is that portion of SERS's capital commitments that was drawn or taken down by the venture capitalist and is readily available for investment; Market Value of Distributions shows the value of the distributions made from each limited partnership to SERS at the time of the transaction.

<i>Venture Capital Limited Partnership</i>	<i>Financing Stage Focus</i>	<i>SERS Initial Funding</i>	<i>Capital Committed (\$ millions)</i>	<i>Capital Drawn (\$ millions)</i>	<i>Market Value of Distributions (\$ millions)</i>
APA/Fostin	Diversified	9/30/87	\$20.0	\$20.0	\$38.3
Advent VII	Diversified	7/30/93	25.0	13.8	4.4
Bachow III	Diversified	11/9/94	25.0	8.2	0.0
CEO Ventures S	Diversified	7/29/87	1.0	1.0	0.7
CEO Ventures II	Diversified	7/14/89	7.5	7.5	0.7
Edison Ventures III	Diversified	3/1/94	25.0	12.5	0.0
Fairview Capital	Minority	9/28/94	10.0	1.0	0.0
Fostin Capital	Diversified	11/25/85	10.0	10.0	4.8
Fostin Capital II	Diversified	10/5/89	7.5	7.5	1.0
Grotech PA III	Diversified	6/29/90	3.0	3.0	0.5
Grotech PA IV	Diversified	11/1/93	25.0	10.4	0.5
Healthcare Venture III	Diversified	7/9/92	15.0	13.9	0.2
Keystone II	Middle/Later	11/25/85	10.0	10.0	20.6
Keystone IV	Middle/Later	7/21/93	15.0	8.0	3.1
NEA VI	Early/Later	3/2/94	25.0	11.9	0.6
NEPA Venture	Seed/Early	8/29/85	2.0	2.0	4.8
NEPA Venture II	Seed/Early	7/24/92	7.5	4.5	0.0
P/A Fund	Diversified	6/2/93	30.0	18.2	0.7
PNC Ventures I	Diversified	11/25/85	5.0	5.0	7.3
Pittsburgh Seed Fund	Seed	1/13/87	2.0	2.0	0.0
Point Venture Partners	Diversified	10/2/90	1.0	1.0	0.4
Polaris Venture Partners	Early Stage	*	15.0	0.0	0.0
RR&Z Private Equity Fund	Diversified	*	20.0	0.0	0.0
Sprout Capital VII	Diversified	2/24/95	18.0	3.6	0.0
Summit Ventures IV	Later	6/27/95	25.0	2.5	0.0
TDH-II	Diversified	11/25/85	9.0	9.0	13.0
Weston Presidio	Diversified	11/27/95	20.0	2.0	0.0
Zero Stage Capital II	Seed	4/30/87	2.0	2.0	0.4
Total			\$380.5	\$190.4	\$102.0

*Commitment approved by the SERS Board of Trustees at the December 1995 meeting.

Summary of *Alternative Investments*

SERS's alternative investment program has commitments to 11 leveraged buyout (LBO) partnership investments, four European venture capital/private equity partnership investments, one special situations/restructuring fund partnership investment, one distressed debt investment fund, two partnerships that invest in secondary interests, and one partnership that specializes in private equity buyout investments while incorporating an Employee Stock Ownership Plan (ESOP) in its acquisition strategy.

LBOs involve acquiring companies using borrowed funds. Usually the target company's assets serve as security for loans taken out by the acquirer. The acquirer repays the loans from cash flow of the acquired company. SERS invests as a limited partner in LBO partnerships formed for the purpose of providing funds, usually in the form of equity interests, for the acquisition of companies. Special situations/restructuring investments operate under a philosophy of flexibility to adapt to market fluctuations and opportunities that exist from the deleveraging of debt-laden companies. Investments are usually made in successful companies that carry high debt levels and seek to deleverage for a variety of reasons. Deleveraging is often used in an attempt to avoid a major restructuring or bankruptcy. Investments are usually "white squire" or friendly "influence block" in nature. A white squire invests in companies that could benefit from the capital and presence of a large and supportive shareholder. Investing in the secondary partnership market involves acquiring interests in established buyout and private equity funds by purchasing existing limited partnership positions at an opportune time in their economic lives and at discounts from their net asset values. Secondary transactions, through the timing of their investments, have the benefit of reduced risk for the asset class, without a reduction in the upside return. SERS is also a limited partner in four European-based venture capital limited

partnerships focused on private equity investing in France, Germany and the United Kingdom (U.K.). Unlike venture capital investing in the U.S., venture investing in Europe is private equity in nature, tends to occur at a much later stage and concentrates on lower technology industries.

Policy

SERS's 1995 Investment Plan targeted an eventual allocation of 3.0% of assets to the alternative investments asset class.

Market Value

SERS's alternative investments program had a \$166.9 million market value, or 1.0% of the total Fund's \$16,185.1 million market value, on December 31, 1995. In total, SERS had committed to invest \$463.5 million in the alternative investments asset class.

Alternative Investments Program

The alternative investments program has commitments to 11 buyout-oriented partnerships. One is Pennsylvania focused; two are Midwest focused; one is focused in the West; two are global in nature; and five are nationally focused. Most are focused on small-to-medium capitalization companies. Only "friendly" acquisitions are pursued. All deals are non-hostile and privately negotiated. Most are non-auction and completed with present management in place. SERS's special situations/restructuring partnerships are nationally focused and can invest in small-to-large capitalization companies. SERS's acquisition/buyout partnership utilizes an ESOP strategy and makes only friendly acquisitions supported by a broad group of the company's management who invariably participate in the equity investment. Ownership is further expanded to other employees in the organization through the implementation of an ESOP strategy, which gives employees a sense of ownership and a financial stake in their company.

SERS's European venture capital investments are comprised of private equity investment in companies based in the U.K. and Europe. The four partnerships focus on the U.K., France, Germany and German-speaking countries. All four funds plan to take advantage of changes occurring within Europe, including the elimination of a number of trade barriers in the European economic community, the reunification of Germany and the disintegration of the former Soviet Union. European venture capital investing focuses on small, rapidly growing companies that do not have access to traditional sources of capital. SERS has committed to a partnership that specializes in distressed debt instruments by investing in debt obligations of financially distressed companies with a view toward converting debt into equity. Debt is converted into equity in order to obtain an equity oriented return.

The partnership is national in focus. Similarly, SERS has another investment, also in distressed debt, but views the opportunity for gains in the appreciation of the debt instrument itself and not the conversion into an equity position.

SERS has also committed to two partnerships that invest in secondary purchases. The partnerships have a national focus and specialize in secondary purchases of established buyout and venture capital holdings. The benefits of secondary purchases are two-fold: 1) They enable the selling limited partners to gain liquidity in an otherwise illiquid investment. (Ordinarily the selling limited partner needs liquidity for non-economic reasons.); and 2) the buyer of a secondary position can usually purchase the investment from a motivated seller at a substantial discount from net asset value.

Alternative Investments Committed, Drawn and Distributed as of Dec. 31, 1995

In the chart below, Capital Committed represents SERS's capital committed to each limited partnership; Capital Drawn is the portion of SERS's capital commitments drawn or taken

down by the general partner and readily available for investment; Distributions is the value of distributions made from each limited partnership to SERS.

<i>Alternative Investments Limited Partnership</i>	<i>Geographic Focus</i>	<i>SERS Initial Funding</i>	<i>Capital Committed (\$ in millions)</i>	<i>Capital Drawn (\$ in millions)</i>	<i>Distributions (\$ in millions)</i>
APAX Capital Risque III	France	11/29/90	\$5.0	\$4.6	\$1.1
APAX German Ventures	Germany	1/30/91	5.0	3.6	2.0
Blackstone Capital II	Global	8/26/94	40.0	9.2	0.0
Brentwood Buyout Fund	National	11/21/88	10.0	10.0	1.2
Charterhouse Equity II	National & PA	3/30/94	40.0	22.8	1.6
Clayton, Dubilier & Rice V	National	5/3/95	50.0	0.6	0.0
Code, Hennessy & Simmons	Midwest & PA	9/28/89	10.0	9.4	12.6
Code, Hennessy & Simmons II	Midwest & PA	7/12/94	20.0	8.7	0.1
Hellman & Friedman II	National	1/7/92	25.0	24.6	6.0
Hellman & Friedman III	National	6/14/95	50.0	12.8	0.0
Kelso Investment Assoc. V	National & PA	1/26/94	40.0	23.9	3.5
Landmark Equity Partners IV	Secondaries	2/28/95	30.5	4.0	1.0
Landmark Equity Partners V	Secondaries	1/27/96	24.0	0.0	0.0
Madison Dearborn	National	2/23/93	15.0	8.8	1.3
Murphy & Fauver	National	10/11/88	5.0	5.0	1.4
OCM Opportunities Fund	Distressed Debt	*	24.0	0.0	0.0
RR&Z PA Fund #1	PA	3/2/88	10.0	10.0	18.1
Schroder Ventures UK III	UK	8/29/89	10.0	8.9	9.4
Schroder Ventures UK IV	UK	*	15.0	0.0	0.0
TCW Special Credits V	National	8/25/94	35.0	29.8	0.0
Total			\$463.5	\$196.6	\$59.3

*Commitment approved by the SERS Board of Trustees at the December 1995 meeting.





SECTION 2

Pennsylvania Investments



Summary of Pennsylvania Investments

Members of the SERS Board, employees of SERS and agents of the Board stand in a fiduciary relationship to the members of SERS regarding the investments and disbursements of the Fund. Subject to restrictions on investments contained in the Retirement Code and the Fiscal Code, the Board has exclusive control and management of the Fund and full power to invest its assets. The Board adopted a formal Statement of Investment Policy in 1979 that has been revised to reflect and incorporate subsequent legislative changes governing investments. Where investment characteristics including yield, risk, and liquidity are equivalent, the Board's policy favors investments that have a positive impact on the

economy of Pennsylvania. SERS's investment portfolios have always had substantial investments in Pennsylvania firms, as some large national firms are headquartered in the Pittsburgh, Philadelphia and Harrisburg areas, including Bell Atlantic, Rite Aid, Westinghouse, Sun, Rohm & Haas, and H. J. Heinz. In addition, SERS has invested in portfolios designed to emphasize investments in Pennsylvania. As of December 31, 1995, SERS had \$1,075.6 million, or approximately 6.6% of SERS's total Fund, invested in Pennsylvania. Of this amount, SERS had placed \$627.9 million in portfolios specially designed for Pennsylvania investments.

Stocks

SERS has two Pennsylvania stock portfolios that increase exposure to "in-state" corporations. SERS's Pennsylvania stock universe is comprised of 553 publicly-traded corporations that: 1) name their headquarters as Pennsylvania and have Pennsylvania employees or operations; or 2) have Pennsylvania-based employment exceeding 25% of total corporate employment. Emerald Advisers, Inc., of Lancaster and Mellon Equity Associates of Pittsburgh actively manage portfolios for SERS

from our Pennsylvania stock universe. The market value of SERS's Pennsylvania stock portfolios was \$107.9 million as of December 31, 1995.

In addition to the Pennsylvania equity portfolios, SERS also had \$304.6 million invested in the 553 Pennsylvania stock universe companies as of December 31, 1995. These stocks were held in SERS's index funds and in SERS's actively managed portfolios.

Fixed Income

As of December 31, 1995, SERS had \$1.5 million invested in loans of the Pennsylvania Private Placement Separate Account designed by the Pennsylvania MILRITE Council and managed by Cigna. This account was created to provide long-term, fixed-rate loans to established Pennsylvania firms that do not have access to the public bond markets. SERS had \$175.7 million invested in Pennsylvania mortgages (\$164.5 million in conventional commercial, and \$11.2 million in

residential properties) as of December 31, 1995. The residential segment of this portfolio is comprised of competitive-rate mortgages distributed solely in Pennsylvania in accordance with SERS's policy to originate 100% of all residential mortgages within the Commonwealth. The commercial segment listed above is comprised of competitive-rate mortgages on various industrial, retail, apartment, and office complexes within Pennsylvania. Legg Mason,

Pennsylvania State Employees' Retirement System

SERS's mortgage advisor, has committed on a best efforts basis under its fiduciary responsibility to invest between 15.0% and 30.0% of SERS's commercial mortgage portfolio in Pennsylvania and 100% of all residential mortgages in Pennsylvania. It is conservatively estimated that as of December 31, 1995, the various commercial projects financed within the Commonwealth by SERS under the commercial mortgage program directly employ over 5,000 workers. This figure does not, however, take into account those who

are employed in the property management and maintenance areas of these projects, nor does it consider the favorable "ripple effect" such jobs may have on the local economy. Additionally, SERS had approximately \$105.8 million invested as of December 31, 1995, in corporate securities issued by Pennsylvania-based companies; these securities are held in SERS's various externally-managed bond portfolios.

Cash

SERS is one of the largest investors in the Short-Term Investment Pool (STIP) managed by the Pennsylvania State Treasury Department. The STIP has significant holdings of 1) certificates of deposit issued by Pennsylvania-based financial institutions, 2) short-term notes and commercial paper issued by Pennsylvania-based companies, 3) notes and obligations of selected Pennsylvania

state agencies, and 4) FNMA mortgage-backed securities backed by loans issued under Pennsylvania's Homestart program. The Homestart program is designed to encourage home ownership within the Commonwealth by making mortgages available to lower, moderate and middle-income Pennsylvania households.

Real Estate

SERS began investing directly in the Pennsylvania commercial real estate market in 1987 and subsequently established two separate account real estate portfolios managed by Heitman/JMB Advisory Corporation and RAI Advisers, Inc. To date these managers have committed to invest approximately 50.0% and 100%, respectively, of their initial allocation in Pennsylvania properties.

As of December 31, 1995, the SERS real estate portfolio contained 27 Pennsylvania investments totaling 6,646,673 square feet of office, retail, hotel, apartment, and warehouse space. The gross market value of these investments totaled \$455.0 million, of which SERS's ownership share was \$198.2 million.

Venture Capital

The SERS venture capital program has committed \$380.5 million to 28 venture capital partnership funds. As a part of its focus, the program targets partnerships that can demonstrate the ability to make investments in companies either based in Pennsylvania or that employ Pennsylvania citizens. These partnerships are diversified among various geographic regions and financing stages

(including four seed funds designated by Pennsylvania's Ben Franklin Partnership). SERS, in conjunction with the Pennsylvania Public School Employees' Retirement System (PSERS), created the APA/Fostin Pennsylvania Venture Capital Fund in 1987 with a commitment of \$20.0 million from each fund. The partnership of Alan Patricof Associates/Fostin Capital manages

this venture capital fund with offices in Philadelphia and Pittsburgh. During 1992, SERS and PSERS committed \$30.0 million each to create the P/A Fund (formerly known as the APA/Fostin Pennsylvania Venture Capital Fund II), which will continue the focus on Pennsylvania venture capital investing.

A key aspect of the SERS venture capital program is the attraction of national funds into Pennsylvania investments. Alan Patricof Associates' expertise as the lead investor in the majority of their investments continues to provide Pennsylvania with a flow of venture capital money from numerous out-of-state funds and investors. The progress of Pennsylvania within the national venture capital community should reap substantial rewards in future years for both Pennsylvania and the SERS Fund. As of December 31, 1995, SERS's venture capital partnerships have attracted over \$340 million of out-of-state funds to finance their active venture companies based in Pennsylvania. After more than 10 years of venture investing, the SERS venture program continues to enhance the pool of venture capital available to Pennsylvania-based companies by attracting larger national venture capital funds into the state. Committed capital and managerial talent of these organizations could substantially increase business creation and job opportunities throughout Pennsylvania. These

national firms also bring investment capital reserves to Pennsylvania and provide a significant opportunity for SERS to leverage its venture capital dollars while promoting economic growth.

SERS has been active in seed and early-stage financing of Pennsylvania-based companies. SERS's investment in the NEPA Venture Fund has, during its 11-year history, provided investments in 26 Pennsylvania-based, technology oriented start-up companies. SERS's commitment to NEPA Venture Fund II will enable NEPA to cover the Pittsburgh area in addition to eastern Pennsylvania. The goal of NEPA Venture Fund II is to invest over the next five years in up to five start-up companies in the Pittsburgh area.

The limited partnerships funded by SERS have made investments in 70 Pennsylvania companies currently active within their portfolio as of December 31, 1995. The Pennsylvania portfolio companies, plus non-Pennsylvania-based companies currently active in SERS's portfolio, employ approximately 4,300 Pennsylvanians and anticipate a 1996 payroll of approximately \$160 million. As of December 31, 1995, \$190.4 million of the \$380.5 million committed to venture capital partnership funds had been drawn down for investment by the partnerships, and \$102 million had been returned to SERS.

Alternative Investments

In 1988, SERS invested \$10 million with RR&Z Pennsylvania Fund #1, a Pittsburgh-based buyout group that invested in non-hostile, "friendly," privately negotiated, non-auction deals completed with present management in place. The LBO fund focuses on small-to-medium capitalization companies (between \$5 million and \$100 million) within a 600-mile radius of western Pennsylvania. Since inception, RR&Z has returned over \$18 million to SERS and has successfully exited four of its five investments. Based on RR&Z's

performance, SERS committed \$20 million in 1995 to the RR&Z Private Equity Fund, a continuation of the strategy developed in Pennsylvania Fund #1. SERS's search for fund managers within alternative investments includes a focus on Pennsylvania-based companies. SERS's commitments to this asset class include Charterhouse Equity Partners and Kelso Investment Associates, which have made Pennsylvania a part of their focus by investing in Pennsylvania-based companies.





SECTION 3

Investment *and* Program Trends

Investment-Related Statistics: 1980 through 1995

Year End	Market Value	# of Investment Advisors	# of Portfolios	# of Consultants	Annual Total Fund Rate of Return (<i>net of fees</i>)
1980	\$2,556,000,000	3	3	3	5.3%
1981	\$2,684,000,000	5	6	3	0.9%
1982	\$3,730,000,000	6	7	4	27.8%
1983	\$4,396,000,000	14	17	4	13.0%
1984	\$4,922,000,000	22	24	4	9.4%
1985	\$5,157,000,000	23	26	3	23.1%
1986	\$7,120,000,000	30	34	3	15.2%
1987	\$7,367,000,000	37	42	3	3.3%
1988	\$8,312,000,000	41	49	3	12.8%
1989	\$9,758,000,000	47	59	4	17.8%
1990	\$9,773,000,000	53	65	4	1.0%
1991	\$11,940,000,000	56	68	4	22.6%
1992	\$12,407,000,000	66	79	4	7.4%
1993	\$13,650,000,000	61	80	4	13.2%
1994	\$13,223,000,000	78	100	4	-1.1%
1995	\$16,185,000,000	84	108	4	25.3%

Investment Performance by Asset Classes

Calendar Year Basis through December 31, 1995*

(net of fees)

Asset Class	One-Year Total Return	Three-Year Total Return	Five-Year Total Return	10-year Total Return
Domestic Stocks	37.0%	14.7%	17.4%	14.2%
<i>Wilshire 5000 Index</i>	36.5%	14.9%	17.3%	14.2%
International Stocks	6.5%	12.1%	10.3%	n/a
<i>SERS Custom International Stock Benchmark</i>	9.1%	17.7%	9.9%	n/a
Fixed Income	20.4%	9.9%	11.3%	10.4%
<i>SERS Custom Fixed Income Benchmark</i>	21.8%	9.2%	10.3%	10.0%
Cash	10.5%	7.0%	7.9%	8.1%
<i>90-day U.S. Treasury Bills</i>	5.9%	4.3%	4.6%	5.9%
Tactical Asset Allocation	35.5%	16.2%	15.9%	n/a
<i>TAA Policy Benchmark</i>	36.2%	15.8%	14.9%	n/a
Real Estate	7.6%	4.8%	0.5%	3.5%
Alternative Investments	11.9%	8.5%	6.4%	n/a
Venture Capital	27.4%	15.1%	13.5%	7.7%
Total Fund	25.3%	11.9%	13.0%	11.4%

*Returns for periods longer than one year are annualized.

Prudent Person

The SERS Board's investment authority is governed by the "prudent person" standard as set forth in Title 71, Pennsylvania Consolidated Statutes, Section 5931(a). Enactment of the prudent person standard in Act 1994-29 and a subsequent asset/liability study completed by RogersCasey and the SERS Investment Office staff are the foundation of SERS's Annual Five Year Investment Plan. With prudent person investment authority, SERS is able to pursue a broader array of investment opportunities that enhance the ability to achieve competitive rates of return while maintaining risk at acceptable levels. Studies undertaken by SERS have demonstrated that the prudent application of this expanded investment authority will result in a more efficient portfolio that better serves the needs of SERS.

Projected Asset Allocation: 1996 through 1999

SERS's annual Investment Plan covers a period of five years. The Fund's asset allocation strategy evolves during this timeframe to achieve the long-term targets for each asset category. The planned evolution of the asset allocation strategy is reflected in the table below.

Asset Allocation Trend*

	1996	1997	1998	1999
Stocks	56.5%	56.5%	56.5%	56.5%
Fixed Income	25.3%	24.0%	23.0%	22.5%
Cash	1.0%	1.0%	1.0%	1.0%
Tactical Asset Allocation**	5.0%	5.0%	5.0%	5.0%
Real Estate	9.0%	9.5%	9.8%	10.0%
Venture Capital	1.5%	1.8%	2.0%	2.0%
Alternative Investments	1.7%	2.2%	2.7%	3.0%
	100.0%	100.0%	100.0%	100.0%

*Source: SERS's 1995 Annual Five Year Investment Plan. **TAA normal position is 70% stocks and 30% bonds. Numbers may not add due to rounding.

Pennsylvania State Employees' Retirement System

**Commissions Paid by SERS Domestic Separate Account Stock Advisors
to Clearing Brokers: Calendar Year 1995**

Broker	Commissions	Broker	Commissions
Lynch Jones & Ryan	\$471,905.60	ISI Group	\$15,582.00
Instinet	471,478.42	SEI Financial Services	15,403.00
Investment Technologies	385,472.63	C. J. Lawrence	15,141.00
Bear Stearns	312,887.99	Citation Group	14,380.00
CS First Boston	227,944.00	Factset Data Systems	13,295.80
Merrill Lynch	206,945.27	Lazard Freres	11,740.00
Goldman, Sachs	182,563.99	Soundview Financial Group	11,856.00
Lehman Brothers	155,760.08	Frank Russell Co.	11,441.00
Jefferies & Co.	119,782.88	Fahnestock & Co.	10,844.00
Morgan Stanley & Co.	114,146.80	Furman Selz Magerdie	10,518.00
Smith Barney	113,056.10	BT Securities	10,123.30
Lewco Securities	100,727.06	Quaker Securities	10,041.36
Capital Institutional Services	98,658.00	Invemed Associates	8,581.00
Donaldson Lufkin & Jenrette	90,535.40	J. P. Morgan Securities	8,046.00
Salomon Brothers	89,858.84	Dean Witter Reynolds	7,866.00
Neuberger & Berman	81,939.00	National Financial Services	7,848.60
Robertson Stephens	78,486.00	Howard Weil	7,580.00
Rochdale Securities	75,262.00	Goldis Pittsburg Institutional Services	7,410.00
W. R. Lazard & Laidlaw	72,342.00	Trinity Securities	7,362.00
York Securities	66,990.00	The Chicago Corporation	7,218.00
Broadcort Capital	63,698.14	Kalb Voorhis & Co.	7,218.00
Montgomery Securities	57,750.00	Interstate/Johnson	7,152.00
Wilshire Associates	57,511.40	Janney Montgomery Securities	7,033.50
NatWest Securities	54,194.00	Gruntal & Company	7,024.00
Cowen & Co.	53,317.00	Equitable Securities	6,408.00
Paine Webber	51,326.22	Legg Mason Wood Walker	6,182.00
Alex Brown & Sons	49,954.00	Ernst & Co.	5,519.00
Prudential Securities	47,045.96	Blair, William & Co.	5,260.00
Sanford C. Bernstein	46,425.30	Dillon, Read & Company	4,638.00
Execution Services	44,586.45	Wessels, Arnold & Henderson	4,806.00
Jones & Associates	37,747.20	Bridge Trading	4,416.00
Deutsche Bank Capital	37,392.00	Raymond W. Baird & Co.	4,272.00
Autranet	34,390.00	Gerard Klauer Mattis	4,224.00
Oppenheimer & Co.	32,900.00	Cantor Fitzgerald	4,043.00
Correspondent Services	28,677.00	Jackson Partners & Associates	3,708.00
Standard & Poor's Securities	28,590.20	Tucker, Anthony & R L Day	3,355.00
Weeden & Company	28,361.00	Raymond James & Associates	2,958.82
S.G. Warburg & Company	27,545.00	Hefren Tillotson	2,149.20
Fidelity Capital Markets	25,214.00	Weiss, Peck & Greer	3,144.00
Alpha Management	23,070.00	McDonald & Co.	3,006.00
J. Streicher	22,215.00	Abel Noser	2,604.00
Wheat First Securities	20,621.50	Davis, Mendel & Regenstein	2,500.00
Fox Pitt Kelton	17,319.50	Robinson - Humphrey Co.	2,330.00
UBS Securities	17,086.00	Boston Institutional	2,100.00
Roulston Research Company	15,865.00	Wedbush Morgan Securities	2,073.00
Keefe Bruyette & Woods	15,613.74	Other Brokers (49)	35,969.64
		Total Brokers (143)	
		Total Commissions	\$4,811,527.89

Commissions Paid by SERS International Separate Account Stock Advisors to Clearing Brokers: Calendar Year 1995

Broker	Commissions	Broker	Commissions
Goldman Sachs	\$342,366.65	SBC Warburg	\$20,483.05
Merrill Lynch	288,243.32	Prudential Securities	20,051.79
James Capel	262,122.84	BSN Sociedad Devalor	18,742.40
BZW Securities	254,514.78	Dai Ichi Securities	18,474.49
Credit Lyonnais	232,791.98	InverMexico	18,215.11
NatWest	183,006.19	Panmure Gordon	17,162.07
Morgan Stanley	176,949.34	Nikko Securities	16,817.50
Baring Securities	172,476.68	Bain Securities	16,397.53
UBS Securities	133,199.77	Asia Equity	15,521.73
Kleinwort Benson	124,516.55	Acciones Y Valores	14,212.01
S. G. Warburg & Co.	116,949.37	Potter Warburg Securities	13,575.53
Warburg Securities	113,339.28	Jeffries & Co.	13,112.10
Smith New Court	111,321.90	Smith Barney	12,902.55
Lehman Brothers	109,678.11	RBC Dominion Securities	12,848.69
Robert Fleming & Co.	87,392.91	Fox Pitt Kelton	12,511.27
Nomura Securities	87,197.21	PT Makindo Indonesia	12,393.63
Bear Stearns	85,212.33	CIBC/Wood Gundy	11,865.09
Salomon Brothers	83,736.60	Exane Paris	11,086.15
Jardine Fleming	78,128.80	New Japan Securities	10,965.05
Marx Casenave & Co.	70,684.84	McIntosh & Co.	10,848.59
Barclays Trust & Banking	66,927.92	Albert E Sharp & Co.	10,299.89
Crosby Securities	54,652.68	Bridge Trading	10,228.10
Garanitia	52,206.29	Svenska International	9,959.42
Societe Generale	49,331.85	Macquarie Bank Sydney	9,046.39
Fledgeling Securities	48,099.82	Tiedemann Securities	8,135.34
Pictet & Company	48,015.01	Schroder Securities, Inc.	7,370.38
Hoare Govett	45,466.49	Sanyo Securities	7,364.28
W. I. Carr	41,428.50	Rand International	7,230.46
Peregrine Brokerage	38,274.46	Morgan Grenfell	7,131.89
CS First Boston	36,909.86	Indeval	6,899.21
Swiss Bank	35,399.94	Rowan Dartington & Co.	6,819.53
Alfred Berg	33,258.10	Worldsec International Securities	6,704.55
Wertheim & Co.	31,414.39	Bank Vontobel	6,442.56
Fiba Nordic Securities	31,082.25	Enskilda Securities	6,355.68
Hyundai Securities	30,152.23	H. Lunden Fonds	6,263.37
Cheuvreux de Virieux	29,058.76	Julius Baer Securities	6,107.03
Paribas	28,269.87	Pacific Equity Ltd.	6,085.67
Daiwa Securities	25,941.95	Kim Eng Securities	6,079.97
Arnhold & S. Bleichroeder	25,765.38	Carnegie	6,028.32
J. P. Morgan	25,594.24	Instinet	6,022.02
Ord Minnett	23,363.11	Other Brokers (80)	176,824.09
G. K. Goh	22,282.01	Total Brokers (162)	
		Total Commissions	\$4,558,309.04

**Commissions Paid by SERS Separate Account Stock Advisors
to Clearing Brokers; 1995-1994 Comparison**

	<i>1995</i>	<i>1994</i>
<i>Domestic Commissions</i>	\$4,811,527.89	\$3,915,049.91
<i>International Commissions</i>	\$4,558,309.04	\$2,664,239.08
<i>Total Commissions</i>	\$9,369,836.93	\$6,579,288.99

The SERS 1994 *Annual Financial Report* listed domestic commissions only. As of our 1995 report, SERS is listing both domestic and international commissions and total commissions paid during the calendar year. Domestic, international and total commissions for calendar year 1994 are provided here for comparison.

Deferred Compensation Program

Act 1987-81 assigned to the SERS Board the responsibility to establish and administer an IRC Section 457 Deferred Compensation Program for Commonwealth officers and employees. Through this program, participants volunteer to build retirement savings by deferring a portion of their salary among seven investment options. The options are U.S. Short Term Money Market, U.S. Aggregate Bond Index, Enhanced U.S. Tactical Asset Allocation, U.S. Extended Market (small to mid-cap), EAFE Equity Index (international stocks), U.S. Stock Index and U.S. Stable Value funds.

1995 Highlights

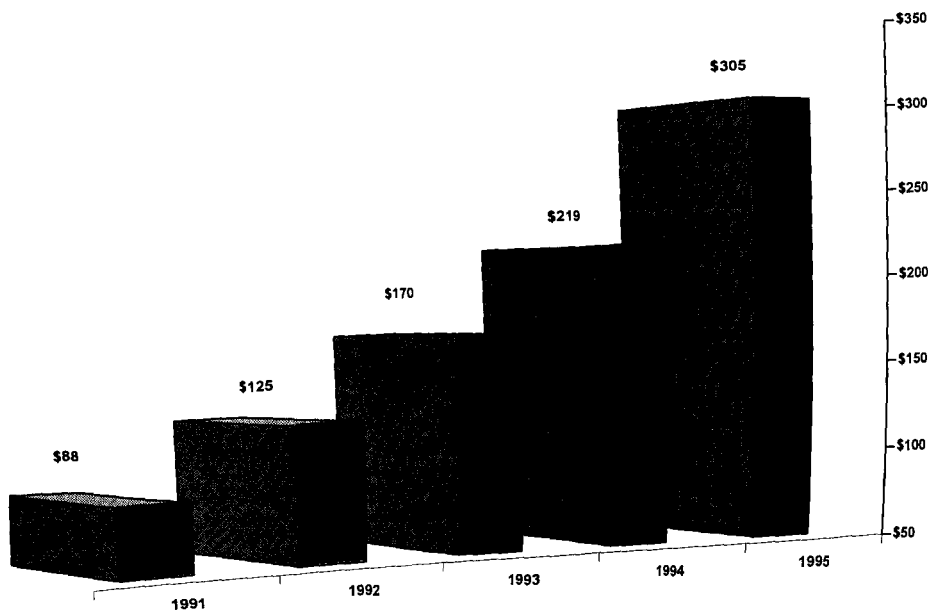
Effective July 1, 1995, as a result of research presented to the Board, the Modified Fixed Annuity product managed by the American United Life Insurance Company (AUL) was changed. Two separate pools of assets were established and the returns blended to form the Stable Value Fund option. The change encompassed the following steps:

- Hiring of Miller, Anderson & Sherrerd (MAS) to manage an active bond pool of assets. This portion of the Stable Value Fund received an initial transfer of over \$40 million from the AUL pool of assets. All future contributions will be directed to this pool.
- Hiring of Providian Capital Management to provide a guaranteed crediting rate for each quarter on the MAS active bond pool.
- Continued use of AUL to manage the balance of the Stable Value Fund's assets. The Board's effort to reduce credit risk exposure will continue with periodic transfers of AUL-managed assets into the active bond pool.

Growth of the Program 1991-1995

During the period from December 31, 1991, through the end of 1995, Deferred Compensation Program assets more than tripled in value from approximately \$88 million to over \$305 million. As of December 31, 1995, there were 22,500 active participants in the program, and the total market value of investments was \$305,723,646.

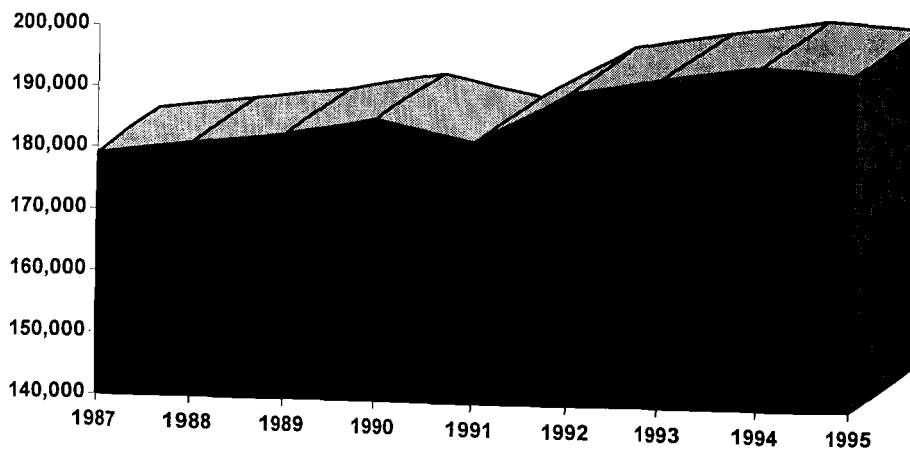
Deferred Compensation Program assets, 1991 through 1995 (\$ in millions)



Member Demographics

<u>Year Ending</u> <u>December 31</u>	<u>Total</u> <u>Members</u>	<u>Active</u> <u>Employees</u>	<u>Former Employees</u> <u>& Survivors</u>
1995	193,841	112,637	81,204
1994	194,955	114,120	80,835
1993	192,652	111,962	80,690
1992	190,101	109,609	80,492
1991	181,971	105,731	76,240
1990	185,470	111,248	74,222
1989	182,649	109,819	72,830
1988	180,927	109,611	71,316
1987	179,014	109,499	69,515

Number of SERS members, 1987 through 1995



Sources: SERS annual Actuarial Reports prepared by Hay/Huggins Company.

Profile of Active Employees as of December 31, 1995

Average Age	44.36
Average Years of Service	14.17

Profile of Annuitants, Beneficiaries and Survivor Annuitants as of December 31, 1995

	Average Age	Average Pension
Superannuation Annuitants	73.9	\$9,801
Early Retirees	57.3	\$7,838
Disabled Annuitants	59.4	\$7,329
Beneficiaries & Survivor Annuitants	75.1	\$4,732

Source: SERS 1995 Actuarial Report, Hay/Huggins Company.

Hay/Huggins Company, Inc.
Actuarial and Benefits Consultants
1500 K Street, N.W.
Washington, DC 20005-1298
Tel: (202) 637-6600
Fax: (202) 637-0160

June 19, 1996

Hay/Huggins
Company

**Retirement Board
Pennsylvania State Employees'
Retirement System
30 North Third Street
Harrisburg, PA 17101**

Dear Board Members:

An actuarial valuation was last performed as of December 31, 1995 to determine actuarial liabilities under the Pennsylvania State Employees' Retirement System. The valuation was carried out in accordance with sound actuarial principles in a manner which, in my opinion, reflects the applicable provisions of the State Employees' Retirement Code. The valuation also served as the basis for determining the contributions required to be made by the Commonwealth to fund the liabilities of the System.

Valuations are made annually based on data supplied by the staff of the Retirement board. The experience under the Retirement System is reviewed every five years. The last such review was for the period of 1991 to 1995. The results of the review are used to develop the assumptions underlying the actuarial valuations. Thus, required contributions are determined on a sound actuarial basis reflecting actual experience under the system.

Sincerely,



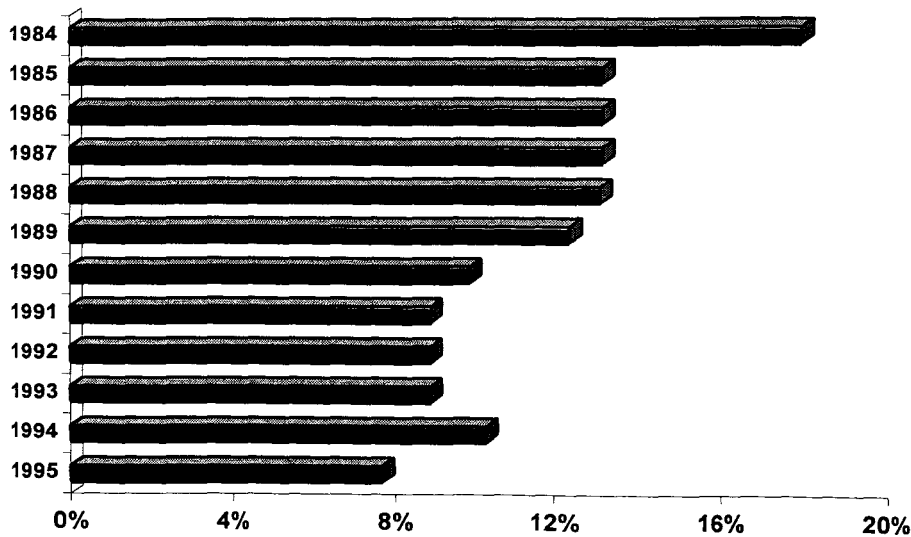
Edwin C. Hustead
Senior Vice President

Contribution Rates

As noted elsewhere in this report, SERS's investments have produced an annualized 10-year investment rate of return of +11.4% after fees, an annualized five-year investment rate of return of +13.0% after fees, and a +25.3% total investment rate of return after fees for the year ended December 31, 1995. As reported in the annual *Actuarial Reports* produced for SERS by

independent actuary Hay/Huggins Company, the Commonwealth's total employer contribution rate was as high as 18.87% of payroll in 1981. Due in part to the substantial investment returns achieved in 1995 and based on the 1995 *Actuarial Report*, the actual employer contribution rate in 1995 was reduced from the 1994 rate of 10.27% of payroll to 7.69% of payroll.

Employer contribution rate by year of valuation, 1984 through 1995*



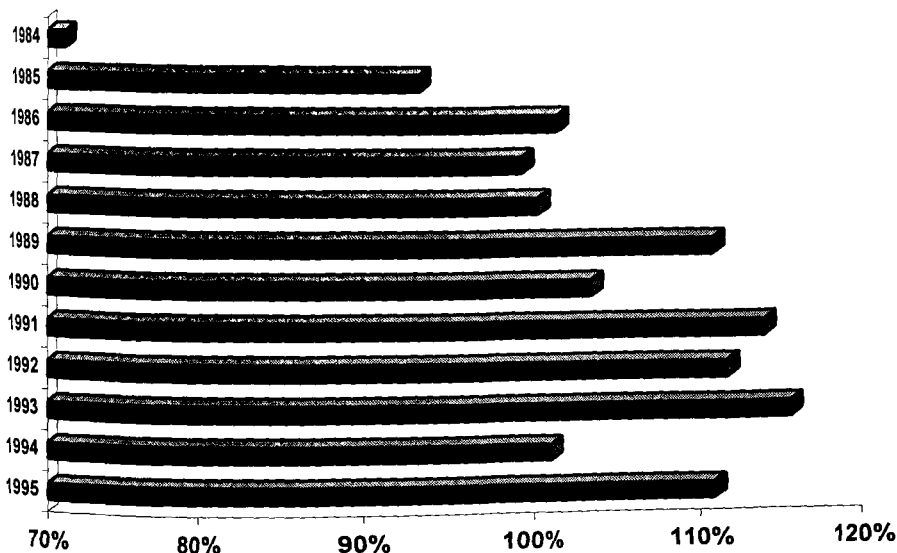
*The total employer cost is the actual contribution rate during the succeeding fiscal year. For instance, the 1995 rate of 7.69% will be the employer contribution rate for fiscal year 1996-1997. Source: SERS 1995 Actuarial Report, Hay/Huggins Company.

Funded Status

Annually, the SERS consulting actuary performs an actuarial valuation, determining, among other things, the funded status of the benefit plan. In 1992, for the first time, the actuarial value of assets exceeded the actuarial accrued liability, meaning the plan attained fully-funded status, with adequate reserves set aside for past service liabilities.

Another measure of funded status adopted by the accounting and actuarial professionals measures the market value of assets against the projected benefit obligation (PBO). The PBO is calculated in conformance with the requirements of Statement No. 5 of the Governmental Accounting Standards Board (GASB). These requirements detail disclosure standards for public pension systems. Under this method of calculation, SERS was 111.2% funded as of December 31, 1995. The recent history of the funded status according to the GASB methodology is depicted below.

SERS funded ratio, 1984 through 1995, in accordance with the Governmental Accounting Standards Board (GASB)*



*Source: SERS actuary, Hay/Huggins Company.





SECTION 4

Report *of* Independent Accountants



REPORT OF INDEPENDENT ACCOUNTANTS

Board of Trustees
Commonwealth of Pennsylvania
State Employees' Retirement System:

We have audited the statements of net assets available for benefits of the Commonwealth of Pennsylvania State Employees' Retirement System (System) as of December 31, 1995 and 1994 and the related statements of changes in net assets available for benefits for the years then ended. These financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial status of the Commonwealth of Pennsylvania State Employees' Retirement System as of December 31, 1995 and 1994, and the changes in its financial status for the years then ended in conformity with generally accepted accounting principles.

As explained in Note 2, the financial statements include investments in real estate, mortgage loans and venture capital valued at \$1,976,676,000 and \$1,862,652,000 as of December 31, 1995 and 1994, respectively (approximately 12% and 14% of net assets as of December 31, 1995 and 1994, respectively), whose values have been estimated by the Board of Trustees, in the absence of readily ascertainable market values. We have reviewed the procedures used in arriving at the estimated values of such investments and have inspected underlying documentation, and, in the circumstances, we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, those estimated values may differ significantly from the values that would have been used had a ready market for the securities existed, and the differences could be material.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The Supplementary Information is presented in accordance with Statement No. 5 of the Governmental Accounting Standards Board for purposes of additional analysis and is not a required part of the basic financial statements. Such information for the years 1986 through 1995 has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the basic financial statements taken as a whole. We previously audited and expressed unqualified opinions on the basic financial statements for the years 1988 through 1994. Such information for the years 1986 and 1987 has been subjected to the auditing procedures applied in the audits of the basic financial statements which were audited by other auditors, whose reports thereon expressed unqualified opinions, and, in their opinion, such information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Coopers & Lybrand L.L.P.

One South Market Square
Harrisburg, Pennsylvania
May 31, 1996

**COMMONWEALTH OF PENNSYLVANIA
STATE EMPLOYEES' RETIREMENT SYSTEM**

STATEMENTS OF NET ASSETS AVAILABLE FOR BENEFITS

as of December 31, 1995 and 1994

	<u>1995</u>	<u>1994</u>
	(000's omitted)	
ASSETS		
Investments at fair value:		
United States Government securities	\$ 1,588,912	\$ 1,607,874
Corporate and foreign bonds and notes	2,096,242	1,918,772
Common and preferred stocks, including collective trust funds	10,012,738	7,588,253
Temporary investments	504,691	193,641
Mortgage loans	448,233	642,265
Real estate	1,191,322	988,568
Venture capital	<u>337,121</u>	<u>231,819</u>
Total investments	16,179,259	13,171,192
Contributions receivable:		
Employers	99,214	84,587
Employees	1,509	2,854
Accrued investment income and other receivables	77,772	82,156
Cash	<u> </u>	<u> 1</u>
Total assets	<u>16,357,754</u>	<u>13,340,790</u>
LIABILITIES		
Accounts payable and accrued expenses	(13,039)	(9,283)
Due to brokers	<u> </u>	<u> (1,231)</u>
Total liabilities	<u>(13,039)</u>	<u>(10,514)</u>
Contingencies (see Note 7)		
NET ASSETS AVAILABLE FOR BENEFITS	<u>\$16,344,715</u>	<u>\$13,330,276</u>

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

Pennsylvania State Employees' Retirement System

**COMMONWEALTH OF PENNSYLVANIA
STATE EMPLOYEES' RETIREMENT SYSTEM**

STATEMENTS OF CHANGES IN NET ASSETS AVAILABLE FOR BENEFITS

for the years ended December 31, 1995 and 1994

	<u>1995</u>	<u>1994</u>
	(000's omitted)	
ADDITIONS:		
Investment income:		
Net appreciation (depreciation) in fair value of investments	\$ 2,761,871	\$ (749,290)
Interest	357,963	478,647
Dividends	162,068	145,192
Other	<u>78,700</u>	<u>69,900</u>
	3,360,602	(55,551)
Less investment expenses	<u>38,240</u>	<u>39,254</u>
	3,322,362	(94,805)
Contributions:		
Employers	384,506	342,927
Employes	<u>201,719</u>	<u>193,204</u>
Total additions	<u>3,908,587</u>	<u>441,326</u>
DEDUCTIONS:		
Benefits and refunds paid to participants	879,717	796,371
Administrative expenses	<u>14,431</u>	<u>15,566</u>
Total deductions	<u>894,148</u>	<u>811,937</u>
Net increase (decrease)	3,014,439	(370,611)
Net assets available for benefits at beginning of year	<u>13,330,276</u>	<u>13,700,887</u>
Net assets available for benefits at end of year	<u>\$16,344,715</u>	<u>\$13,330,276</u>

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

**COMMONWEALTH OF PENNSYLVANIA
STATE EMPLOYES' RETIREMENT SYSTEM**

NOTES TO FINANCIAL STATEMENTS

Description of the System:

The State Employees' Retirement System (System) is the administrator of a cost-sharing multiple-employer retirement system established by the Commonwealth of Pennsylvania (Commonwealth) to provide pension benefits for employees of state government and certain independent agencies. At December 31, 1995, there were 109 participating state and independent agencies. The System is considered part of the Commonwealth of Pennsylvania financial reporting entity and is included in the Commonwealth's financial reports as a pension trust fund.

Membership in the System is mandatory for most state employees. Members and employees of the General Assembly, certain elected or appointed officials in the executive branch, department heads and certain employees in the field of education are not required, but are given the option to participate. At December 31, 1995 and 1994, System membership consisted of:

	<u>1995</u>	<u>1994</u>
Retirees and beneficiaries currently receiving benefits and terminated employees entitled to benefits but not yet receiving them	84,928	85,290
Current employees:		
Vested	67,594	66,320
Nonvested	<u>45,043</u>	<u>47,800</u>
Total members	<u>197,565</u>	<u>199,410</u>

The System provides retirement, death, and disability benefits. Retirement benefits vest after 10 years of credited service. Employees who retire at age 60, or with 35 years of service if under age 60, are entitled to a normal annual retirement benefit. Members of the legislature and certain employees classified in hazardous duty positions can retire with full benefits at age 50.

NOTES TO FINANCIAL STATEMENTS, Continued

1. Description of the System, continued:

The general annual benefit is 2% of the member's highest three-year average salary times years of service. Members of the legislature who were members of the System before March 1, 1974 are entitled to a benefit of 7.5% of final average salary for each year of legislative service. State police are entitled to a benefit equal to a percentage of their highest annual salary, excluding their year of retirement. The benefit is 75% of salary for 25 or more years of service and 50% of salary for 20-24 years of service.

Covered employes are required to contribute to the System at a rate of 5% of their gross pay. A higher contribution rate of 18.75% is required of members of the General Assembly in office prior to March 1, 1974. Judges and district justices have the option of electing special membership classes requiring a contribution of 10.0% and 7.5%, respectively, regardless of their date of entry into state employment. The contributions are recorded in an individually identified account which is also credited with interest, calculated quarterly to yield 4% per annum, as mandated by statute. Accumulated employe contributions and credited interest, which amounted to \$2,499,485,000 and \$2,353,000,000 as of December 31, 1995 and 1994, respectively, vest immediately and are returned to the employe upon termination of service if the employe is not eligible for other benefits.

Participating agency contributions are also mandated by statute and are based upon an actuarially determined percentage of gross pay that is necessary to provide the System with assets sufficient to meet the benefits to be paid to System participants.

According to the retirement code, all obligations of the System will be assumed by the Commonwealth should the System terminate.

2. Significant Accounting Policies:

Basis of Accounting:

The financial statements are prepared using the accrual basis of accounting, under the provisions of Financial Accounting Standards Board No. 35, "Accounting and Reporting by Defined Benefit Pension Plans." The System follows Statements No. 3, "Deposits with Financial Institutions, Investments (Including Repurchase Agreements), and Reverse Repurchase Agreements," and No. 5, "Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers," of the Governmental Accounting Standards Board (GASB) for reporting and disclosure purposes.

NOTES TO FINANCIAL STATEMENTS, Continued

Significant Accounting Policies, continued:**Use of Estimates:**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make significant estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. These significant estimates include the accumulated plan benefits and market values of investments. Actual results could differ from those estimates.

Risks and Uncertainties:

Plan contributions and the actuarial present value of accumulated plan benefits are prepared based on certain assumptions pertaining to interest rates, inflation rates and employee demographics, all of which are subject to change. Due to uncertainties inherent in the estimations and assumptions process, it is at least reasonably possible that changes in these estimates and assumptions in the near term could have a material impact on the financial statements.

Valuation of Investments:

The System records its investments at fair value which is determined differently for each investment type. Marketable securities, which consist primarily of debt and equity securities, are stated principally at market value. Securities traded on a national securities exchange are valued at the last reported sales price on the last day of business of each plan year. Securities which were not traded on the last day of the plan year or which were not traded on a national securities exchange are valued by the respective fund manager or other third parties based on similar securities sales. Temporary investments are valued at cost, which approximates market value.

The fair value of the participation units owned by the System in the collective trust funds was based on quoted redemption value on the last business day of the year.

Mortgage loans are valued by the mortgage advisors using a discounted cash flow method. Venture capital pools are stated at fair values as determined principally by the respective general partners of the venture capital funds and accepted by the respective valuation committees. The valuation committees consider various factors including financial condition, operating results and the nature of the investment.

2. Significant Accounting Policies, continued:

Valuation of Investments, continued:

Real estate investments are stated at estimated fair market value based on an appraisal report prepared by an independent real estate appraiser (member of the American Institute of Real Estate Appraisers). This estimated fair market value is determined in accordance with the policies and procedures of the American Institute of Real Estate Appraisers. This estimated fair market value does not necessarily represent the price at which the investment would sell since market prices of real estate investments are determined by negotiation between a willing buyer and seller. As a result, actual sales price may differ from the fair market value estimates. Management believes that this estimated fair market value is a reasonable approximation of market price.

The System presents in the statements of changes in net assets available for benefits the net appreciation (depreciation) in the fair value of its investments which consists of the realized gains or losses and the unrealized appreciation (depreciation) on those investments. Realized gains or losses on sales of investments are determined on a specific identification or average cost basis, depending upon the type of investment.

3. Funding Status and Progress:

The amount shown as "pension benefit obligation" is a standardized disclosure measure of the present value of pension benefits, adjusted for the effects of projected salary increases, estimated to be payable in the future as a result of employe service to date. The measure is the actuarial present value of credited projected benefits and is intended, on an ongoing basis, to facilitate the assessment of the System's funding status and progress made in accumulating sufficient assets to pay benefits when due and to allow for appropriate comparison of this data among public employe retirement systems. The pension benefit obligation is calculated based on GASB Statement No. 5 and is independent of the actuarial funding method used to determine contributions to the System as discussed in Note 4.

The pension benefit obligation was determined as part of an actuarial valuation at December 31, 1995 and 1994. Significant actuarial assumptions used include (a) a rate of return on the investment of present and future assets of 8.5% and 9.25% per year compounded annually in 1995 and 1994, respectively, (b) projected salary increases of 3.3% and 4.0% per year compounded annually in 1995 and 1994, respectively, (c) additional projected salary increases of approximately 3.5% and 2.7% in 1995 and 1994, respectively, attributable to merit/promotion, and (d) no post-retirement benefit increases.

NOTES TO FINANCIAL STATEMENTS, Continued

Funding Status and Progress, continued:

The pension benefit obligation at December 31, 1995 and 1994 is as follows:

	<u>1995</u>	<u>1994</u>
	(000's omitted)	
Pension benefit obligation:		
Retirees and beneficiaries currently receiving benefits and terminated employes entitled to benefits but not yet receiving them	\$ 5,715,086	\$ 5,117,258
Current employes:		
Accumulated employe contributions and credited interest	2,468,148	2,349,731
Employer-financed, vested	6,004,866	5,219,026
Employer-financed, nonvested	<u>559,013</u>	<u>485,856</u>
Total pension benefit obligation	14,747,113	13,171,871
Net assets available for benefits, at fair value	<u>16,344,715</u>	<u>13,330,276</u>
Net assets in excess of pension benefit obligation	<u>\$ 1,597,602</u>	<u>\$ 158,405</u>

A comparative 10-year summary of the pension benefit obligation, which has been calculated in accordance with the requirements of GASB Statement No. 5, is presented as supplementary information following the notes to the financial statements. This information is presented for purposes of an additional analysis of the System's progress in accumulating sufficient assets to pay benefits when required. The calculation of the pension benefit obligation under GASB Statement No. 5 differs from the calculation required under Financial Accounting Standards Board (FASB) Statement No. 35 of the actuarial present value of accumulated plan benefits principally by the consideration of future salary increases and the use of an 8.5% and 9.25% assumed rate of return on investments in 1995 and 1994, respectively.

NOTES TO FINANCIAL STATEMENTS, Continued

3. Funding Status and Progress, continued:

The significant actuarial assumptions used in the valuations of the actuarial present value of accumulated plan benefits under FASB Statement No. 35 as of December 31, 1995 and 1994 are as follows:

Mortality:	
Superannuation (normal retirement and early retirement)	Current Retirees, Beneficiaries and Survivors: The 1971 Group Annuity Mortality Table, set back 6 years for females
	Current and Future Employees: The 1983 Group Annuity Mortality Table
Disability	Modifications of the Federal Civil Service Disability Mortality Table
Assumed rate of return on investments	7.25% and 7.75% in 1995 and 1994, respectively

The accumulated plan benefit information at December 31, 1995 and 1994 is as follows:

	<u>1995</u>	<u>1994</u>
	(000's omitted)	
Actuarial present value of accumulated plan benefits:		
Vested benefits:		
Participants currently receiving payments	\$ 6,109,425	\$ 5,551,363
Other participants	<u>6,222,296</u>	<u>5,654,105</u>
	12,331,721	11,205,468
Nonvested benefits	<u>254,196</u>	<u>200,517</u>
Total	<u>\$12,585,917</u>	<u>\$11,405,985</u>

NOTES TO FINANCIAL STATEMENTS, Continued

Funding Status and Progress, continued:

The changes in the actuarial present value of accumulated plan benefits for the years ended December 31, 1995 and 1994 are as follows:

	<u>1995</u>	<u>1994</u>
	(000's omitted)	
Actuarial present value of accumulated plan benefits at January 1	\$11,405,985	\$10,631,427
Increase (decrease) during the year attributable to:		
Passage of time and other causes	522,143	421,308
Change in plan provisions		353,250
Change in actuarial assumptions:		
Interest rates	300,740	
Mortality tables	<u>357,049</u>	<u> </u>
Actuarial present value of accumulated plan benefits at December 31	<u>\$12,585,917</u>	<u>\$11,405,985</u>

The actuarial assumption change causing the largest increase in cost in 1995 was the change in the demographic assumption from the 1971 Group Annuity Mortality Table (GAM - 71) to the 1983 Group Annuity Mortality Table (GAM - 83) for current and future employees to reflect continuing mortality improvement. The GAM - 71 table continues to apply for current retirees.

The 1994 change in plan provisions resulted primarily from Act 1994-29 (the Act) which was enacted on April 29, 1994 and, among other things, provided a cost of living adjustment (COLA) to annuitants with an effective date of retirement on or prior to June 30, 1992. The COLA provides for an additional monthly annuity of between 1.50% to 7.90% based on date of retirement. The Act also provides for a monthly longevity supplement for members with 20 or more years of service with a date of retirement on or before July 1, 1984.

Contributions:

The System funding policy provides for periodic member contributions at statutory rates and employer contributions at actuarially determined rates (expressed as a percentage of annual gross pay) that are sufficient to accumulate assets to pay benefits when due. All required contributions were made for the years 1995 and 1994.

NOTES TO FINANCIAL STATEMENTS, Continued

4. Contributions, continued

Employer contribution rates are determined using the entry age normal actuarial cost method, with amortization of the unfunded actuarial liability and of supplemental annuities arising from cost of living and other adjustments over 20-year periods. These rates are computed based upon actuarial valuations on the Commonwealth's fiscal year of June 30; therefore the employer contribution rates in effect for the System's year end of December 31 reflect a blended average of the rates as calculated. The blended contribution rates were as follows:

	<u>1995</u>	<u>1994</u>
Employer normal cost	10.48%	10.02%
Amortization of unfunded actuarial asset	(2.30)	(2.13)
Amortization of supplemental annuities	<u>1.22</u>	<u>1.01</u>
Total employer cost	<u>9.40%</u>	<u>8.90%</u>

The make-up of employer cost reflects the System's assumptions, primarily as they relate to investment returns, future salary increases and acts of legislature, thereby reallocating the components of total employer cost.

Significant structural changes have occurred based on the 1991 through 1995 study of the actuarial experience of SERS. These changes affect the actuarial assumptions used to compute employer's contribution requirements. The most significant structural change was to move to a flat assumed rate of return of 8.5%. The prior year valuation had been based on an investment rate assumed to be 9.9% through 2000 and then graded down to 6% after 2015 which was equivalent to the 9.25% investment return rate used in the projected benefit obligation calculation in 1994. The change to the flat rate of 8.5% will reduce the employer cost effective for the Commonwealth's fiscal year beginning July 1, 1996.

NOTES TO FINANCIAL STATEMENTS, Continued

5. Investments:

As provided by statute, the System's Board of Trustees (Board) has exclusive control and management responsibility of System funds and full power to invest the funds. In exercising its fiduciary responsibility to System membership, the Board is governed by the "prudent person" rule, which requires the exercise of due care in establishing investment policy, and has adopted its Statement of Investment Policy to formally document investment objectives and responsibilities. This policy, as well as applicable state law, defines permissible investments of the System, including all investment types held in the portfolio at December 31, 1995 and 1994 and at all times during the years.

The investments of the System at December 31, 1995 and 1994 have been categorized to indicate the level of risk assumed by the System, in accordance with GASB Statement No. 3. In accordance with a contractual relationship between the Commonwealth's Treasury Department and a custodial agent, substantially all securities subject to categorization are held in book entry form in a unique account so as to be identified at all times as the possession of the Commonwealth; all such investments, as well as certain securities held in physical form at the Commonwealth's Treasury Department, the statutory custodian of the Fund, are reflected in Category 1, which is defined as securities insured or registered, or held by the System or its agent in the System's name. GASB Statement No. 3 provides for Category 2 and 3 investments, which reflect a higher risk. The System has no holdings of these types at December 31, 1995 and 1994. Certain investments have not been categorized because securities are not used as evidence of the investment. The investments not categorized include ownership interests in collective trust funds, mortgage loans, real estate and venture capital pools.

Pennsylvania State Employees' Retirement System

NOTES TO FINANCIAL STATEMENTS, Continued

5. Investments, continued

Summary of Investment Risk

	<u>Fair Value</u>	
	<u>1995</u>	<u>1994</u>
	(000's omitted)	
Category 1:		
United States Government securities	\$ 1,013,019	\$ 1,296,836
Corporate bonds and notes	1,844,235	1,635,910
Common and preferred stocks	2,043,836	2,330,872
International securities	<u>1,849,990</u>	<u>1,105,308</u>
	<u>6,751,080</u>	<u>6,368,926</u>
Not Categorized:		
Investments held by broker/dealers under reverse repurchase agreements:		
United States Government securities	575,893	311,038
Corporate bonds and notes	38,748	16,500
Common and preferred stocks	191,413	2,105
International securities	255,983	93,076
Collective trust and mutual funds	5,884,775	4,323,254
Temporary investments	504,691	193,641
Mortgage loans	448,233	642,265
Real estate	1,191,322	988,568
Venture capital	<u>337,121</u>	<u>231,819</u>
	<u>9,428,179</u>	<u>6,802,266</u>
Total investments	<u>\$16,179,259</u>	<u>\$13,171,192</u>

The System's investments are managed by various fund managers. At December 31, 1995 and 1994 respectively, two external investment advisory firms managed approximately 47.5% and 44% of the System's total investment portfolio assets. Most of these assets consist of collective trusts and mutual funds and are passively managed in nature. The allocations to these two investment advisory firms are fully consistent with the System's Annual Five Year Investment Plan and Statement of Investment Policy. Because the System's assets are invested in a variety of financial instruments, the related values as presented in the financial statements are subject to various market fluctuations which include changes in the equity markets, interest rate environment and the general economic conditions.

The System's investments in real estate are concentrated principally in office, industrial, retail, and residential projects. Approximately \$199,014,000 and \$190,290,000 of the real estate portfolio is located in Pennsylvania as of December 31, 1995 and 1994, respectively. The System's remaining real estate investments are not concentrated in any one geographic area or industry.

NOTES TO FINANCIAL STATEMENTS, Continued

5. Investments, continued:

The System participates in a security lending program, whereby certain securities are transferred to an independent broker/dealer in exchange for collateral equal to at least 102% of the market value of securities on loan (reverse repurchase agreements). As the System represents only one of several Commonwealth agencies participating in the security lending program and, as collateral received by the custodial agent in exchange for System securities is not specifically identifiable by agency, the System does not record the receipt of such collateral or the corresponding liability to return collateral via repurchase of securities under loan. Securities under loan, however, are maintained on the System's financial records and have been classified accordingly in the summary of investment risk. The System has minimized its exposure to credit risk due to broker/dealer default by having the custodial agent determine daily that required collateral meets 102% of the market value of securities on loan. The System has not experienced any losses due to credit risk on security lending activity since implementation of the program.

These financial instruments necessarily involve counterparty credit exposure. The policy of the System is to require collateral to the maximum extent possible under normal trading practices. In the event of counterparty default, the System has the right to use the collateral to offset the loss associated with the replacement of the exchange agreements. Specific credit limits have been established for each counterparty and are monitored and adjusted daily. The limits are developed based on the counterparty's creditworthiness, overall industry and other considerations, such as the length and legal structure of the contract, type of collateral advanced, and historical volatility indicators.

The System uses financial instruments including forward exchange contracts to manage market exposure. These instruments are integral to the asset allocation, risk management and control systems of the System's investment management strategies and practices. These strategies include holdings of certain foreign debt and equity securities which amounted to approximately \$2.2 billion and \$1.6 billion at December 31, 1995 and 1994, respectively. As a result of these strategies, the System enters into forward exchange contracts as hedges relating to specific foreign security positions. Those instruments are designed to minimize exposure and reduce risk from foreign exchange rate fluctuations. Gains and losses on forward exchange contracts which hedge foreign securities are recognized as incurred. Such amounts effectively offset gains and losses on the foreign currency assets which are hedged. The System does not enter into forward contracts on a speculative basis.

Pennsylvania State Employees' Retirement System

NOTES TO FINANCIAL STATEMENTS, Continued

5. Investments, continued:

At December 31, 1995, the System had contracts maturing through March 27, 1996 to purchase or sell foreign currency as follows:

	Buy at <u>Spot Rate</u>	(000's omitted) Sell at <u>Spot Rate</u>	Net (Payable) <u>Receivable</u>
Deutsche Mark		\$113,461	\$(113,461)
French Franc	\$23,661	52,256	(28,595)
Swedish Kroner	147	5,704	(5,557)
Japanese Yen	4,438	171,545	(167,107)
Other	<u>13,382</u>	<u>115,707</u>	<u>(102,325)</u>
	<u>\$41,628</u>	<u>\$458,673</u>	<u>\$(417,045)</u>

At December 31, 1994, the System had contracts maturing through April 5, 1995 to purchase or sell foreign currency as follows:

	Buy at <u>Spot Rate</u>	(000's omitted) Sell at <u>Spot Rate</u>	Net (Payable) <u>Receivable</u>
Deutsche Mark	\$13,456	\$17,329	\$ (3,873)
French Franc	13,511	27,912	(14,401)
Swedish Kroner		12,935	(12,935)
Japanese Yen		19,001	(19,001)
Other	<u>7,442</u>	<u>12,842</u>	<u>(5,400)</u>
	<u>\$34,409</u>	<u>\$90,019</u>	<u>\$(55,610)</u>

There were aggregate unrealized gains of approximately \$3.9 million and \$1.2 million, and aggregate unrealized losses of approximately \$0.6 million and \$1.3 million for these forward contracts at December 31, 1995 and 1994, respectively.

The System's investments, including investments bought, sold, as well as held during the year appreciated (depreciated) in fair value by \$2,761,871,000 and \$(749,290,000) in 1995 and 1994, respectively.

NOTES TO FINANCIAL STATEMENTS, Continued

5. **Investments, continued:**

The fair value of individual investments that represent 5% or more of the System's net assets available for benefits are as follows:

	<u>1995</u>	<u>1994</u>
	(000's omitted)	
Wells Fargo Nikko Investment Advisors:*		
Equity Index Fund P - 160,197,334 and 131,531,390 units in 1995 and 1994, respectively	\$3,456,964	\$2,064,180
70/30 Enhanced U.S. Tactical Asset Allocation Fund - 44,765,633 and 48,985,876 units in 1995 and 1994, respectively	\$ 875,397	\$ 706,476
Extended Equity Market Fund - 15,304,050 and 16,348,703 units in 1995 and 1994, respectively	\$ 956,246	\$ 764,328

The 70/30 Enhanced U.S. Tactical Asset Allocation Fund is diversified among three collective funds: equity, which is invested primarily in Standard & Poor's 500 Companies; long-term fixed income, which is invested in corporate notes and bonds; and the short-term cash fund, which is invested in money market instruments.

During the year ended December 31, 1995, the System earned \$613,000 of accrued benefits resulting from a commission recapture program. As a result, the System realized savings of approximately \$587,000 on consulting, advisory and other expenditures. At December 31, 1995 and 1994, the System had accumulated \$425,000 and \$399,000, respectively, of benefits which were available to use for future expenditures.

6. **Income Taxes:**

Management believes the System meets the definition of a Governmental Plan and in the System's communications with the Internal Revenue Service (IRS) has been treated as a qualified plan. Therefore, the System has not requested a determination letter from the IRS relating to the status of the System under the Internal Revenue Code.

7. **Contingencies:**

The System is involved in various lawsuits which, if settled adversely, would not have a material effect on the financial statements in management's opinion. However, the individual cases involve legal issues that, if extended to the entire membership, may result in significant costs to the System. If such an event were to occur, the additional costs would be recovered by the System through adjustments to the employer contribution rate.

* Now known as BZW Barclays.

NOTES TO FINANCIAL STATEMENTS, Continued

8. New Accounting Pronouncements:

Several new accounting pronouncements were issued which the System will be required to adopt over the next few years as follows: Statement of Governmental Accounting Standards Board (GASB) 25, Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans (effective for the year ending December 31, 1997), GASB 27, Accounting for Pensions by State and Local Governmental Employers (effective for the year ending December 31, 1998), and GASB 28, Accounting and Financial Reporting for Securities Lending Transactions (effective for the year ending December 31, 1996).

GASB 25 establishes a financial reporting framework for defined benefit pension plans that distinguishes between two categories of information: (a) current financial information about plan assets and financial activities and (b) actuarially determined information, from a long-term perspective, about the funded status of the plan and the progress being made in accumulating sufficient assets to pay benefits when due.

GASB 27 establishes standards for the measurement recognition and display of pension expenditures/expense and related liabilities, assets, note disclosures, and required supplementary information in the financial reports of state and local government employers.

GASB 28 establishes accounting and financial reporting standards for securities lending transactions. In these transactions, governmental entities transfer their securities to broker-dealers and other entities for collateral which may be cash or securities and simultaneously agree to return the collateral for the same securities in the future. Securities lending transactions will now be recorded in the balance sheet with the costs of these lending transactions reported as expenditures or expenses.

SUPPLEMENTARY INFORMATION

COMMONWEALTH OF PENNSYLVANIA
STATE EMPLOYEES' RETIREMENT SYSTEM

TEN-YEAR HISTORICAL TREND INFORMATION

Analysis of Funding Progress
(in millions of dollars)
at December 31, 1995

	(1)	(2)	(3)	(4)	(5)	(6)
				Unfunded (Assets in Excess of) Pension Benefit Obligation	Annual Covered Payroll	Unfunded (Assets in Excess of) Pension Benefit Obligation as a Percentage of Annual Covered Payroll
Fiscal Year	Net Assets Available for Benefits*	Pension Benefit Obligation	Percentage Funded (1)/(2)	(2)-(1)		(4)/(5)
1986	\$ 7,120	\$ 6,984	101.9%	\$ (136)	\$2,518	(5.4)%
1987	\$ 7,367	\$ 7,384	99.8%	\$ 17	\$2,663	0.6%
1988	\$ 8,312	\$ 8,257	100.7%	\$ (55)	\$2,779	(2.0)%
1989	\$ 9,785	\$ 8,782	111.4%	\$(1,003)	\$2,998	(33.5)%
1990	\$ 9,886	\$ 9,536	103.7%	\$ (350)	\$3,197	(10.9)%
1991	\$11,940	\$10,465	114.1%	\$(1,475)	\$3,120	(47.3)%
1992	\$12,453	\$11,146	111.7%	\$(1,307)	\$3,359	(38.9)%
1993	\$13,701	\$11,854	115.6%	\$(1,847)	\$3,546	(52.1)%
1994	\$13,330	\$13,172	101.2%	\$ (158)	\$3,714	(4.3)%
1995	\$16,345	\$14,747	110.8%	\$(1,598)	\$3,816	(41.9)%

Analysis of the dollar amounts of net assets available for benefits, pension benefit obligation, and unfunded (assets in excess of) pension benefit obligation in isolation can be misleading. Expressing the net assets available for benefits as a percentage of the pension benefit obligation provides one indication of the System's funding status on a going-concern basis. Analysis of this percentage over time indicates whether the system is becoming financially stronger or weaker. Generally the greater this percentage, the stronger the plan. Trends in unfunded (assets in excess of) benefit obligation and annual covered payroll are both affected by inflation. Expressing the unfunded (assets in excess of) pension benefit obligation as a percentage of annual covered payroll approximately adjusts for the effects of inflation and aids analysis of the System's progress made in accumulating sufficient assets to pay benefits when due. Generally, where there is an unfunded pension benefit obligation the smaller this percentage, the stronger the plan. However, when assets are in excess of pension benefit obligation the higher the bracketed percentage, the stronger the plan.

* Reflects investment valuation at fair value (Note 2).

Pennsylvania State Employees' Retirement System

SUPPLEMENTARY INFORMATION

**COMMONWEALTH OF PENNSYLVANIA
STATE EMPLOYEES' RETIREMENT SYSTEM**

TEN-YEAR HISTORICAL TREND INFORMATION

**Revenues by Source and Expenses by Type
(in thousands of dollars)
at December 31, 1995**

Fiscal Year	Revenues by Source				Employer Contributions as a Percentage of Annual Covered Payroll
	Employee Contributions	Employer Contributions*	Investment Income**	Total	
1986	\$139,454	\$407,276	\$ 916,323	\$ 1,463,053	16.2 %
1987	\$147,061	\$366,463	\$ 223,382	\$ 736,906	13.8 %
1988	\$153,131	\$382,413	\$ 929,778	\$ 1,465,322	13.8 %
1989	\$164,653	\$416,513	\$ 1,464,707	\$ 2,045,873	13.8 %
1990	\$175,422	\$418,655	\$ 114,174	\$ 708,251	13.1 %
1991	\$182,611	\$381,347	\$ 2,154,276	\$ 2,718,234	12.2 %
1992	\$187,167	\$319,093	\$ 857,770	\$ 1,364,030	9.5 %
1993	\$190,360	\$304,122	\$ 1,534,370	\$ 2,028,852	8.6 %
1994	\$193,204	\$342,927	\$ (94,805)	\$ 441,326	9.2 %
1995	\$201,719	\$384,506	\$ 3,322,362	\$ 3,908,587	10.1 %

* Contributions were made in accordance with actuarially determined contribution requirements.

** Includes net realized and unrealized appreciation (depreciation) in fair value of investments and is net of investment expense.

Fiscal Year	Expenses by Type			
	Benefit Payments	Refunds of Employee Contributions	Administrative Expenses	Total
1986	\$483,603	\$11,338	\$ 4,938	\$499,879
1987	\$474,598	\$10,671	\$ 4,811	\$490,080
1988	\$504,697	\$10,446	\$ 5,391	\$520,534
1989	\$556,324	\$10,777	\$ 6,028	\$573,129
1990	\$589,832	\$ 9,693	\$ 7,400	\$606,925
1991***	\$645,936	\$ 9,736	\$ 8,380	\$664,052
1992***	\$829,533	\$ 9,719	\$11,501	\$850,753
1993	\$761,993	\$ 6,804	\$12,527	\$781,324
1994	\$788,330	\$ 8,041	\$15,566	\$811,937
1995	\$869,896	\$ 9,821	\$14,431	\$894,148

* In 1991, 6,700 members elected early retirement resulting in accelerated pension benefits principally in 1992.



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