# Fairfax County Employees' Retirement System

A Pension
Trust Fund of
Fairfax County
Virginia

# Comprehensive Annual Financial Report

*For the Fiscal Year Ended June 30, 2003*

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FAIRFAX
COUNTY
V I R G I N I A

BOARD OF TRUSTEES
EMPLOYEES' RETIREMENT SYSTEM
10680 Main Street, Suite 280
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November 15, 2003

Dear Members of the Board of Trustees:

I am pleased to submit to you the annual report of the Fairfax County Employees' Retirement System ("System") for the fiscal year ended June 30, 2003. This annual report is provided as an aid to understanding the structure and evaluating the status of the System. The System's management is responsible for the accuracy of financial information contained herein.

The annual report for fiscal year 2003 consists of five sections: (1) an Introductory Section that contains this transmittal letter along with the organization structure and review of plan provisions; (2) a Financial Section that contains the opinion of the independent auditors, management's discussion and analysis, the financial statements of the System and required supplementary information; (3) an Investment Section that contains investment results; (4) an Actuarial Section that includes the independent actuary's certification letter, a summary of the results of the actuarial valuation, and actuarial procedures and assumptions; and (5) a Statistical Section that contains information regarding the System membership.

**History**

The Fairfax County Supplemental Retirement System was established on July 1, 1955. On February 26, 2001 the name of the System was changed to the Fairfax County Employees' Retirement System. The System is a cost-sharing multiple-employer public employee retirement system providing defined benefit pension plan coverage to full-time and certain part-time Fairfax County and Fairfax County Public Schools employees who are not covered by the Fairfax County Police Officers Retirement System, the Fairfax County Uniformed Retirement System, the Educational Employees' Supplementary Retirement System of Fairfax County (ERFC) or the Virginia Retirement System (VRS). There were 14,065 active members and 4,388 retirees participating in the System as of June 30, 2003.

**Benefit Provisions**

The benefit provisions of the System are established by County Ordinance. The System provides normal service retirement and early service retirement benefits for members who attain age or service requirements. Coverage for service-connected disability benefits is immediate upon membership in the System. Ordinary (non-service related) disability benefits are provided after the attainment of five years of service. Members are vested after five years of service and are eligible for benefits at the early or normal service retirement date.

**Capital Markets and Economic Conditions**

Fiscal 2003 was characterized by the continuation of the bear market through mid-March and much more favorable market conditions during the final quarter of the year. Even with the market rebound, the S&P 500 index returned 0.26% for the year. Fortunately, the bond market was strong as evidenced by the Lehman Aggregate Bond Index return of 10.40%. With the market rally, the Employees' Retirement System fund returned 12.59% in the quarter ending June 30, 2003 and finished with a fiscal year return of 5.88%, before management fees. The full year return placed the fund in the 15th percentile of the Russell/Mellon public fund universe and the fund's three year returns placed in the 12th percentile. The returns for the total fund exceeded the policy benchmark for the year, and the returns of each major asset class exceeded the relevant indices.

After accounting for all cash flows, including contributions, expenses, and benefit payments, the market value of the System's net assets increased 3.7%, from $1.717 billion on June 30, 2002 to $1.780 billion on June 30, 2003.

**Major Initiatives**

Following established policy of having a periodic actuarial audit, a parallel valuation of liabilities was completed by an independent actuarial firm. The actuarial audit report certified that the liabilities and costs computed by the plan's actuaries as of July 1, 2001 were computed in accordance with generally accepted actuarial principles.

After having the plan terms reviewed by outside counsel and obtaining approval of a number of recommended technical amendments, an application was submitted to the Internal Revenue Service to obtain an updated letter confirming the plan continues to qualify as an employee benefit plan under section 401(a) of the Internal Revenue Code.

A restructuring of the plan's investments in the fixed income asset class was completed. A number of changes designed to further diversify the asset class and to obtain improved risk adjusted returns over the long term were implemented. In addition to a core portfolio, the fixed income asset class now includes specialized portfolios in international (non-U.S.) bonds, Treasury Inflation Protected Securities (TIPS), mortgage-backed securities, high yield bonds, and duration management.

**Internal and Budgetary Controls**

The System's management is responsible for maintaining internal accounting controls to provide reasonable assurance that transactions are properly authorized and recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America.

The final report and recommendations resulting from the investigation of an embezzlement discovered in fiscal 2002 was received. The report did not identify any control deficiencies other than those already addressed during fiscal 2002. A number of recommendations unrelated to the embezzlement have also been implemented to improve the back-up and disaster recovery capabilities related to computer application systems. Based on the recent intensive audit review, we believe the internal controls in effect adequately safeguard the System's assets and provide a reasonable assurance regarding the proper recording of financial transactions. In addition, the budget for the System is annually presented and approved by the Board of Trustees and the County's Board of Supervisors.

**Funded Status**

An actuarial valuation of the System to determine funding requirements is performed annually. The System's funding policy provides for periodic employer contributions at actuarially determined rates which will remain relatively level over time as a percentage of payroll and will accumulate sufficient assets to meet the costs of benefit payments when due. The valuation of the System performed as of July 1, 2002 indicated that the ratio of assets accumulated by the System to total actuarial accrued liabilities for benefits decreased from 97.3% to 90.4%. The Actuarial Section contains further information on the results of the July 1, 2002 valuation.

**Investment Policies and Strategies**

The Board of Trustees has an adopted Statement of Investment Objectives and Policy. This Statement establishes the investment goals, guidelines, constraints and performance standards that the Board of Trustees uses when exercising its fiduciary duties to manage the investment assets of the System. The Board operates in conformity with the standard of care required in making investments as stated in the Code of Virginia §51.1-124.30.C.

The Board receives quarterly reporting from staff to ensure compliance with its stated objectives and policy. Staff also monitors the performance of the System and its investment managers. Rate of return information is included in the Investment Section.

Securities of the System except for mutual funds and the County's pooled cash and temporary investments are held by Mellon Global Securities Services as agent, in the System's name. Mellon Financial Corporation, the parent company, carries Financial Institution Bond insurance coverage including a Computer Crime Policy. An additional Excess Securities policy covers all risk of physical loss to securities.

**Other Information**

*Independent Audit and Actuarial Certifications*

The independent auditors' report and certifications from the actuary are included in this report.

*Acknowledgements*

The annual report of the Employees' Retirement System was prepared by the System's staff under the leadership of the Board of Trustees. I would like to thank staff who have worked hard throughout the year to ensure the successful operation of the System. This report is intended to provide complete and reliable information for determining the financial status of the System. It is being submitted to the Board of Supervisors and other interested parties and is available to the public via the County's website located at www.fairfaxcounty.gov/retbrd/.

Respectfully submitted,

Laurnz A. Swartz
Executive Director

## BOARD OF TRUSTEES

## ADMINISTRATIVE ORGANIZATION

### Administrative Staff

Laurnz A. Swartz
*Executive Director*

Thomas H. Weaver
*Senior Investment Manager*

Philip R. Langham
*Retirement Administrator*

### Professional Services

**Actuary**

Milliman USA
Actuaries
Vienna, VA

**Auditor**

KPMG LLP
Certified Public Accountants
Washington, DC

### Investment Managers

Barclays Global Investors
San Francisco, CA

Brandywine Asset Management
Wilmington, DE

Bridgewater Associates, Inc.
Westport, CT

The Clifton Group
Minneapolis, MN

Cohen & Steers Capital Management, Inc.
New York, NY

DSI International Management, Inc.
Norwalk, CT

JP Morgan Fleming Investment Management, Inc.
New York, NY

Lazard Asset Management
New York, NY

MacKay Shields
New York, NY

Peregrine Capital Management
Minneapolis, MN

M.W. Post Advisory Group LLC
Los Angeles, CA

Shenkman Capital Management
New York, NY

Standish Mellon Asset Management
Pittsburgh, PA

Trust Company of the West
Los Angeles, CA

Thomson Horstmann & Bryant, Inc.
Saddle Brook, NJ

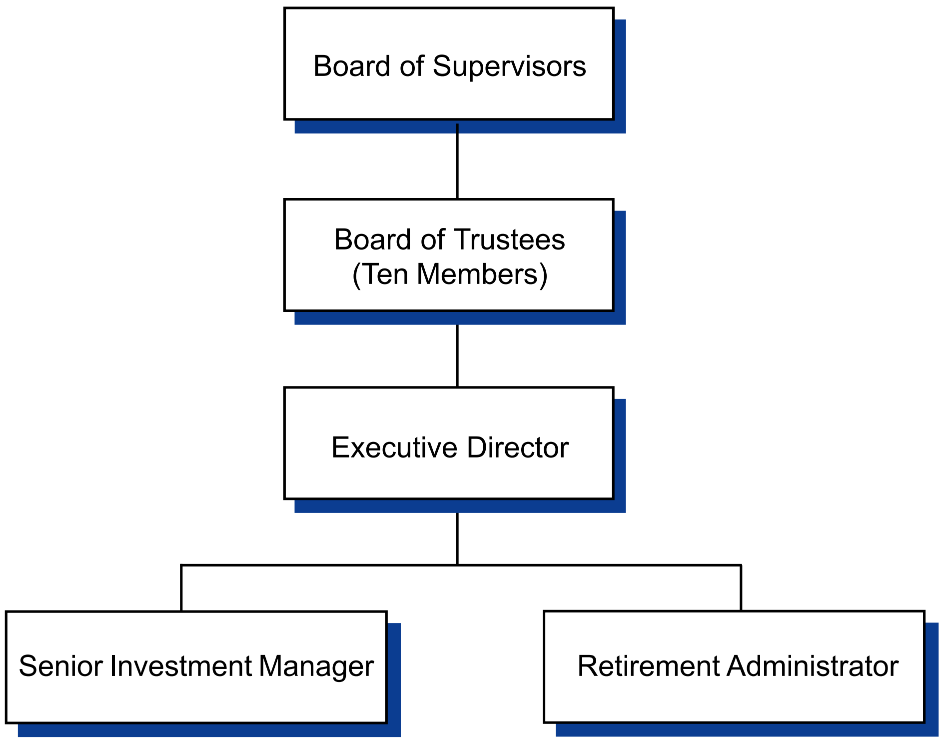
Robert E. Torray & Co., Inc.
Bethesda, MD

Wanger Asset Management, L.P.
Chicago, IL

### Custodial Bank

Mellon Global Securities Services
Pittsburgh, PA

## ORGANIZATIONAL CHART



## SUMMARY OF PLAN PROVISIONS

Membership in the Fairfax County Employees' (formerly Supplemental) Retirement System includes most County employees working at least 20 hours per week as well as part-time and support staff employees from the Fairfax County Public Schools. The System consists of two Plans, Plan A and Plan B which have slightly different employee contribution rates and slightly different benefits. In all other respects, the plans are identical. The employee has the option to enroll in either plan within 30 days of employment. This choice is irrevocable. Employees who make no election default to retirement Plan A.

The general provisions of the Employees' Retirement System are as follows:

### Plan A

**Contribution Rate:**

4% of base salary up to the maximum Social Security wage base plus 5.333% of base salary over the wage base.

**Benefit:**

1.8% of average final compensation (highest consecutive three years) up to the Social Security Breakpoint times creditable service plus 2% of average final compensation which exceeds the Social Security Breakpoint times creditable service. The total benefit is then increased by 3%. The Social Security Breakpoint is an average of Social Security wage bases for the last 35 years before a member reaches age 65.

In addition, at the time of normal service retirement, a Pre-Social Security Benefit is payable at the rate of 1% of average final compensation up to the Social Security Breakpoint times creditable service. This benefit will be payable until the member reaches the age of eligibility for unreduced Social Security benefits. The total benefit is then increased by 3%.

### Plan B

**Contribution Rate:**

5.333% of base salary.

**Benefit:**

2% of average final compensation (highest consecutive three years) times creditable service. The total benefit is then increased by 3%.

In addition, at the time of normal service retirement, a Pre-Social Security Benefit is payable at the rate of 1% of average final compensation up to the Social Security Breakpoint times creditable service. This benefit will be payable until the member reaches the age of eligibility for unreduced Social Security benefits. The total benefit is then increased by 3%.

### Both Plans

**Normal Retirement:**

is either age 65 with at least 5 years of service or at least age 50 when the member's age plus creditable service (including sick leave) totals 80 or more.

## SUMMARY OF PLAN PROVISIONS
(Continued)

**Early Retirement:**
is at age 50 or older when the member's age plus creditable service totals 75 or more. Reduction factors are applied to the basic formula for early retirement and no Pre-Social Security Benefit is payable.

**Deferred Vested Retirement:**
is available for vested members (vesting is at 5 years of creditable service) who leave their contributions in the System when they terminate. These members are entitled to their normal retirement benefit based on service with the County at age 65 or a reduced benefit earlier when they reach age 50 and age plus years of creditable service equal 75. This benefit is then increased by 3%.

**Service-Connected Disability Retirement:**
is available for members, regardless of their length of service, who become disabled as a result of a job-related illness or injury. Benefits are $66^2/_3$% of average final compensation.

**Ordinary Disability Retirement:**
is available for vested members who become disabled due to an injury or illness that is not job-related. Benefits are 2% of average final compensation (highest consecutive three years) times creditable service. The total benefit is then increased by 3%.

**Death Benefits:**
*Before Retirement* — If the member is vested and the spouse is the beneficiary, the spouse may elect to receive 50% of the normal retirement benefit earned as of the date of the member's death. This benefit ceases if the spouse remarries before age 60. If this benefit is not elected, a refund of the member's contributions and interest is payable to the named beneficiary.

*After Retirement* — Refund of any of the member's contributions and interest not already paid in benefits will be payable to the named beneficiary(ies) unless the member has elected the irrevocable Joint and Last Survivor Option which provides a benefit to the member's spouse for life. At retirement, the member may choose to have his or her spouse receive 50%, $66^2/_3$%, 75% or 100% of the member's reduced annuity upon the member's death. The member's annuity is reduced by a percentage based on the difference in age between the member and his or her spouse. If the spouse pre-deceases the member, the annuity is restored to what it would have been if this option had not been elected.

*Service-Connected Death Benefit* — A $10,000 lump-sum payment is made to the beneficiary if the member's death is due to a job-related illness or injury.

**Cost of Living Benefit:**
Annual cost of living adjustments are provided to retirees and beneficiaries equal to the lesser of 4 percent or the percentage increase in the Consumer Price Index for theWashington Consolidated Metropolitan Statistical Area.

KPMG LLP
2001 M Street, NW
Washington, DC 20036

**Independent Auditors' Report**

The Board of Supervisors
County of Fairfax, Virginia

The Board of Trustees
of the Fairfax County Employees' Retirement System:

We have audited the statements of plan net assets of the Fairfax County Employees' Retirement System (the System), a pension trust fund of the County of Fairfax, Virginia, as of June 30, 2003 and 2002, and the related statements of changes in plan net assets for the years then ended. These basic financial statements are the responsibility of the System's management. Our responsibility is to express an opinion on these basic financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the basic 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 basic financial statements referred to above present fairly, in all material respects, the plan net assets as of June 30, 2003 and 2002, and the changes in plan net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis on pages 13 through 15 and the required supplementary information on pages 23 and 24 are not required parts of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were conducted for the purpose of forming an opinion on the System's basic financial statements. The introductory, investment, actuarial, and statistical sections are presented for purposes of additional analysis and are not a required part of the basic financial statements. The information in these sections has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we express no opinion on it.

KPMG LLP

October 17, 2003

## MANAGEMENT'S DISCUSSION AND ANALYSIS

This section presents management's discussion and analysis of the Fairfax County Employees' Retirement System's ("System" or "plan") financial performance and provides an overview of the financial activities for the fiscal years ended June 30, 2003 and 2002. The information in this section should be reviewed in conjunction with the letter of transmittal provided in the Introductory Section of this report.

### Overview of Financial Statements and Accompanying Information

**Basic Financial Statements.** The System presents Statements of Plan Net Assets as of June 30, 2003 and 2002 and Statements of Changes in Plan Net Assets for the years then ended. These statements reflect the resources available for the payment of benefits as of year-end and the sources and uses of those funds during the year.

**Notes to Financial Statements.** The Notes to Financial Statements are an integral part of the financial statements and include additional information and schedules to provide a better understanding of the financial statements. The Notes to Financial Statements immediately follow the basic financial statements.

**Required Supplementary Information.** The Required Supplementary Information and related notes provide information regarding the System's funding progress and employer contributions. The Required Supplementary Information and related notes are immediately following the Notes to Financial Statements.

### Financial Analysis

**Summary of Plan Net Assets.** As indicated in the following Summary Statement of Plan Net Assets, the net assets held in the System increased $63.2 million or 3.7% during fiscal 2003 and declined $95.0 million or 5.2% during fiscal 2002. These changes are primarily due to increases in fair value during fiscal 2003 and declines in fair value during fiscal 2002.

**Return on Investments.** The System's return on investments net of investment management fees for fiscal 2003 and 2002 were +5.6% and -4.2%, respectively. Domestic equities had a +0.3% total return in fiscal 2003, after losing a cumulative 30.2% during fiscal 2001 and 2002. International equities exhibited mixed results; developed equity markets fell 6.1% while emerging markets increased 7.0%. On the fixed income side, the Lehman Brothers Aggregate Bond Index gained 10.4% for fiscal 2003. The NAREIT Equity index return for fiscal 2003 was 4.0% and REITs were the best performing sector during fiscal 2002. Additional investment market commentary is provided in the Investment Section of this document.

**Summary of Additions and Deductions.** As presented in the Summary of Additions and Deductions (also included in this section), fiscal year 2003 experienced an overall increase due to investment income while fiscal 2002 experienced an overall reduction due to investment losses. Investment performance was very good in relative terms during both years. The System's return on investments ranked in the top quartile of public funds during fiscal 2003 and was in the top third of public funds in fiscal 2002.

**Additions.** Total additions increased $166.6 million from fiscal 2002 to 2003 primarily due to increases in investment returns. Employer contributions increased $0.9 million or 2.9% from fiscal 2002 to 2003 and $1.1 million or 3.7% from fiscal 2001 to 2002. These increases are attributable to increases in the covered payroll base during the two years. Plan member contributions increased during both years as a

## MANAGEMENT'S DISCUSSION AND ANALYSIS
(Continued)

result of the increase in covered payroll. The System experienced net investment gains during fiscal 2003. The fair value of investments increased $24.9 million during fiscal 2003 as opposed to the $124.5 million loss experienced during fiscal 2002. Interest and dividend income was $71.8 million during fiscal 2003 an increase of 31.5% from $54.6 million during fiscal 2002. Investment activity expense increased $2.0 million or 34.5%, due to investment management fees computed on the increasing investment values and a change to record investment fees deducted directly from pooled investments as expenses. These fees had previously been netted into return on investments. Net securities lending income decreased $238 thousand in fiscal 2003 compared with the same period a year ago. This was due to a combination of factors, including: a lower level of overall interest rates that could be earned on cash collateral, a lessening in demand for securities by borrowers, particularly in international markets, and the change in lending agents with the custodian change during fiscal 2002.

**Deductions.** Benefit payments increased 12.3% from fiscal 2002 to 2003 and 13.2% from fiscal 2001 to 2002. The number of retirees and beneficiaries collecting benefits and the amount of the average benefit increased in both years and were responsible for the increase in the expense. Retirees received cost of living increases of 3.0% as of July, 2002 and 3.4% as of July 1, 2001. Refunds and other expenses declined 6.8% from fiscal 2002 to 2003 and 13.2% from fiscal 2001 to 2002. The amount of refunds varies from year to year based on changes in employee turnover rates and decisions of terminated employees.

The actuarial valuation performed as of July 1, 2002, showed the System's funded status at 90.4%, a decrease of 6.9 percentage points from the July 1, 2001 funded percentage of 97.3%.

### Major Initiatives

Following policy established by the Board of Trustees, the System engaged an independent actuary to perform an actuarial audit during fiscal 2003. The audit report certified that the liabilities and costs computed by the System's actuaries as of July 1, 2001 were computed in accordance with generally accepted actuarial principles.

The plan document was reviewed by outside counsel and a number of recommended amendments were enacted. An application was submitted to the Internal Revenue Service to obtain an updated letter confirming that the plan continues to qualify as an employee benefit plan under section 401(a) of the Internal Revenue Code.

The System's fixed income investments were restructured during fiscal 2003. A number of changes were made to further diversify the asset class and to obtain improved risk adjusted returns over the long term. The fixed income class now includes specialized portfolios in international (non-US) bonds. Treasury Inflation Protected Securities (TIPS), mortgage-backed securities, high yield bonds and duration management, in addition to a core portfolio.

### Contacting the System's Financial Management

This financial report is designed to provide our membership, the Board of Trustees and the County's Board of Supervisors with a general overview of the System's financial condition. If you have any questions about this report or need additional financial information, contact the Fairfax County Retirement Administration Agency, 10680 Main Street, Suite 280, Fairfax, Virginia 22030. This report can also be found on the County's website at www.fairfaxcounty.gov/retbrd/.

## MANAGEMENT'S DISCUSSION AND ANALYSIS
(Continued)

### Summary Statement of Plan Net Assets

| | 2003 | 2002 | Difference | 2001 | Difference |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Total cash and investments | $1,904,782,300 | $ 1,877,949,208 | $ 26,833,092 | $ 2,037,470,490 | $ (159,521,282) |
| Total receivables | 23,626,194 | 75,173,098 | (51,546,904) | 59,165,786 | 16,007,312 |
| **Total Assets** | 1,928,408,494 | 1,953,122,306 | (24,713,812) | 2,096,636,276 | (143,513,970) |
| **Liabilities** | 148,294,754 | 236,186,735 | (87,891,981) | 284,655,900 | (48,469,165) |
| **Net Assets** | $ 1,780,113,740 | $ 1,716,935,571 | $ 63,178,169 | $ 1,811,980,376 | $ (95,044,805) |

### Summary of Additions and Deductions

| | 2003 | 2002 | Difference | 2001 | Difference |
|---|---|---|---|---|---|
| **Additions** | | | | | |
| **Contributions** | | | | | |
| Employer | $ 31,983,708 | $ 31,083,805 | $ 899,903 | $ 29,960,984 | $ 1,122,821 |
| Plan members | 25,467,082 | 24,217,436 | 1,249,646 | 22,553,731 | 1,663,705 |
| Net investment income (loss) | 89,440,289 | (75,059,747) | 164,500,036 | (9,245,125) | (65,814,622) |
| **Total Additions** | 146,891,079 | (19,758,506) | 166,649,585 | 43,269,590 | (63,028,096) |
| **Deductions** | | | | | |
| Benefit payments | 79,442,356 | 70,703,828 | 8,738,528 | 62,431,928 | 8,271,900 |
| Refunds and other | 4,270,554 | 4,582,471 | (311,917) | 5,280,130 | (697,659) |
| **Total Deductions** | 83,712,910 | 75,286,299 | 8,426,611 | 67,712,058 | 7,574,241 |
| **Net Change** | $ 63,178,169 | $ (95,044,805) | $ 158,222,974 | $ (24,442,468) | $ (70,602,337) |

## STATEMENTS OF PLAN NET ASSETS

as of June 30, 2003 and 2002

| Assets | 2003 | 2002 |
|---|---|---|
| Equity in County's pooled cash and temporary investments | $ 4,360,347 | $ 5,796,299 |
| Contributions receivable | 914,714 | 897,189 |
| Accrued interest and dividends receivable | 7,932,458 | 8,736,053 |
| Receivable from sale of investments | 14,779,022 | 65,539,856 |
| Investments | | |
| U.S. Government obligations | 53,984,312 | 35,195,576 |
| Asset-backed securities | 137,563,371 | 221,500,421 |
| Corporate bonds | 191,559,760 | 172,235,627 |
| Common and preferred stock | 737,668,112 | 553,089,059 |
| Pooled and mutual funds | 539,920,139 | 601,016,065 |
| Short-term investments | 114,640,946 | 210,329,707 |
| Cash collateral received under securities lending agreements | 125,085,313 | 78,786,454 |
| Total investments | 1,900,421,953 | 1,872,152,909 |
| Total assets | 1,928,408,494 | 1,953,122,306 |
| **Liabilities** | | |
| Payable for collateral received under securities lending agreements | 125,085,313 | 78,786,454 |
| Payable for purchase of investments | 20,393,272 | 155,083,830 |
| Accounts payable and accrued expenses | 2,816,169 | 2,316,451 |
| Total liabilities | 148,294,754 | 236,186,735 |
| **Net assets held in trust for pension benefits** | **$ 1,780,113,740** | **$ 1,716,935,571** |

(A schedule of funding progress is presented on page 23.)

See accompanying notes to financial statements.

## STATEMENTS OF CHANGES IN PLAN NET ASSETS

For the Years Ended June 30, 2003 and 2002

| | 2003 | 2002 |
|---|---|---|
| **Additions** | | |
| Contributions | | |
| Employer | $ 31,983,708 | $ 31,083,805 |
| Plan members | 25,467,082 | 24,217,436 |
| Total contributions | 57,450,790 | 55,301,241 |
| Investment income | | |
| *From investment activities* | | |
| Net appreciation (depreciation) in fair value of investments | 24,969,994 | (124,527,165) |
| Interest | 52,881,972 | 36,873,130 |
| Dividends | 18,986,056 | 17,774,635 |
| Total investment income | 96,838,022 | (69,879,400) |
| Investment activity expenses | | |
| Management fees | 6,983,778 | 4,983,067 |
| Custodial fees | 214,131 | 268,642 |
| Consultant | 98,500 | 86,000 |
| Allocated administration expense | 422,393 | 401,770 |
| Total investment expenses | 7,718,802 | 5,739,479 |
| Net income (loss) from investment activities | 89,119,220 | (75,618,879) |
| *From securities lending activities* | | |
| Securities lending income | 1,662,248 | 2,459,065 |
| Securities lending expenses | | |
| Borrower rebates | 1,204,713 | 1,611,984 |
| Management fees | 136,466 | 287,949 |
| Total securities lending expenses | 1,341,179 | 1,899,933 |
| Net income from securities lending activities | 321,069 | 559,132 |
| Total net investment income | 89,440,289 | (75,059,747) |
| **Total additions** | 146,891,079 | (19,758,506) |
| **Deductions** | | |
| Annuity benefits | 71,933,909 | 63,723,688 |
| Disability benefits | 5,553,041 | 5,291,660 |
| Survivor benefits | 1,955,406 | 1,688,480 |
| Refunds | 3,425,017 | 3,774,942 |
| Administrative expense | 845,537 | 807,529 |
| **Total deductions** | 83,712,910 | 75,286,299 |
| **Net increase (decrease)** | 63,178,169 | (95,044,805) |
| **Net assets held in trust for pension benefits** | | |
| Beginning of fiscal year | 1,716,935,571 | 1,811,980,376 |
| **End of fiscal year** | **$ 1,780,113,740** | **$ 1,716,935,571** |

See accompanying notes to financial statements.

## NOTES TO THE FINANCIAL STATEMENTS

For the Years Ended June 30, 2003 and 2002

The Fairfax County Employees' Retirement System ("System" or "plan") is considered part of the County of Fairfax, Virginia's ("County") reporting entity and its financial statements are included in the County's basic financial statements as a pension trust fund.

### A. Summary of Significant Accounting Policies

*Basis of Accounting.* The System's financial statements have been prepared under the accrual basis of accounting in accordance with accounting principles applicable to governmental units in the United States of America. Member and employer contributions to the plan are recognized in the period in which the contributions are due. Benefits and refunds are recognized when due in accordance with the terms of the plan. The cost of administering the plan is paid by the System.

*Method Used to Value Investments.* Short-term investments are reported at cost, which approximates fair value. All other investments are reported at fair value. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. Asset-backed securities are valued on the basis of future principal and interest payments and are discounted at prevailing interest rates for similar instruments. The System records investment purchases and sales as of the trade date. These transactions are not finalized until the settlement date, which occurs approximately three business days after the trade date. The amounts of trade receivables and payables are shown as receivables and payables on the Statements of Plan Net Assets. Cash received as collateral on securities lending transactions and investments made with such cash are reported as assets along with a related liability for collateral received.

*Equity in County's pooled cash and temporary investments.* The System maintains cash with the County, which invests cash and allocates interest earned, net of a management fee, on a daily basis to the System based on the System's average daily balance of equity in pooled cash. As of June 30, 2003 and 2002 the bank balance of the County's public deposits was either insured by the Federal Deposit Insurance Corporation or through the State Treasury Board pursuant to the provisions of the Security for Public Deposit Act.

### B. Plan Description and Contribution Information

*Membership.* At July 1, 2002, the date of the latest actuarial valuation, membership in the System consisted of:

| | |
|---|---|
| Retirees and beneficiaries receiving benefits | 4,164 |
| Terminated plan members entitled to but not yet receiving benefits | 413 |
| Active plan members | 14,185 |
| **Total** | **18,762** |

*Plan Description.* The System is a cost-sharing multiple-employer defined benefit pension plan which covers employees of the County and its component units. The plan covers full-time and certain part-time County, Public Schools, Economic Development Authority and Fairfax County Redevelopment and Housing Authority employees who are not covered by other plans of the County or the Virginia Retirement System. Benefit provisions are established and may be amended by County ordinance. All benefits vest at five years of service. To be eligible for normal retirement, an individual must meet the

## NOTES TO THE FINANCIAL STATEMENTS
(Continued)

following criteria: (a) attain the age of 65 with five years of service, or (b) attain the age of 50 with age plus years of service being greater than or equal to 80. The normal retirement benefit is calculated using average final compensation (i.e., the highest consecutive three years) and years, or partial years, of service at date of termination. The plan provides that unused sick leave credit may be used in the calculation of average final compensation by projecting the final salary during the unused sick leave period. The benefit for early retirement is actuarially reduced and payable at early termination.

Annual cost-of-living adjustments are provided to retirees and beneficiaries equal to the lesser of 4 percent or the percentage increase in the Consumer Price Index for the Washington Consolidated Metropolitan Statistical Area.

*Contributions.* The contribution requirements of the System members are established and may be amended by County ordinances. Members may elect to join Plan A or Plan B. Plan A requires member contributions of 4 percent of compensation up to the social security wage base and 5.33 percent of compensation in excess of the wage base. Plan B requires member contributions of 5.33 percent of compensation. The County is required to contribute at an actuarially determined rate; the rates for the fiscal years ended June 30, 2003 and 2002 were 6.00 percent and 6.12 percent of annual covered payroll, respectively.

*Deductions.* The deductions from the System include the payment of retiree and beneficiary benefits, the refund of employee contributions to former members and other expenses.

### C. Investments

The authority to establish the System is set forth in Section 51.1-800 *Code of Virginia* (Code). Section 51.1-803 of the Code authorizes fiduciaries of the System to purchase investments *with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of like character and with the same aims. Such investments shall be diversified so as to minimize the risk of large losses unless under the circumstances it is clearly prudent not to do so.*

The System does not have investments (other than U.S. Government and U.S. Government guaranteed obligations) in any one organization that represent 5 percent or more of net assets available for benefits. All investments, except for the mutual funds, short-term investment fund, and a short-term collateral investment pool, are held by an unaffiliated custodian in the name of the System. Investment decisions for these assets are made by the Board of Trustees or investment managers selected by the Board.

*Derivative Financial Instruments*. As permitted by the Code described above, the System holds off-financial-statement derivatives in the form of exchange-traded financial futures contracts and swap contracts in accordance with Board of Trustees' policy.

An exchange-traded financial futures contract is a legally-binding agreement to buy or sell a financial instrument in a designated future month at a price agreed upon by the buyer and seller at initiation of the contract. Futures contracts are standardized according to quality, quantity and delivery time. Exchange-traded financial futures contracts are used to adjust asset class exposures to achieve target allocations to U.S. and foreign equities and fixed income in the form of U.S. Treasury securities. Futures provide a means to achieve these exposures in a more efficient way and at lower transaction

## NOTES TO THE FINANCIAL STATEMENTS
(Continued)

costs. To achieve the U.S. equity exposure, S&P 500 and Russell 2000 futures contracts are purchased and sold. To obtain the target level of exposure to foreign equities, multiple foreign stock index and currency contracts are purchased and sold. To maintain the target level of exposure to fixed income, three U.S. Treasury futures contracts are purchased and sold. At June 30, 2003 the S&P 500 and Russell 2000 futures contract notional value was a net of $125,238,875, the foreign equity futures notional contract value was $28,610,732, the foreign currency futures notional value was $26,518,748 and the net U.S. Treasury notional value was $(41,292,317). Hang Seng futures contracts, which have notional value of $1,413,352, mature in July, 2003. The remaining futures all mature in September, 2003. The market and interest rate risks of holding exchange traded futures contracts arise from adverse changes in market prices and interest rates. These risks are equivalent to holding exposure to the indexes.

An interest rate swap is a binding agreement between counterparties to exchange periodic interest payments on some predetermined dollar principal, which is called the notional principal amount. Total return interest rate swap contracts are held by one investment manager to replicate the benchmark set for that manager, which is a customized Lehman Brothers U.S. inflation linked index customized to the duration of the Lehman Brothers U.S. Treasury Index. Under the swap, the System pays the counterparty a floating rate payment based on 3-month U S Dollar-LIBOR-British Bankers' Association. In addition, a total return amount is paid or received based on the total return of the underlying security. The effective date of the swap is June 2, 2003 and the swap matures on June 2, 2004. Payment occurs on the 15th of July and October, 2003, and January and April, 2004. The fair and notional values of the swap at June 30, 2003 were $(219,274) and $51,468,268, respectively. The counterparty credit risk is equal to the amount of profit or loss that has not yet been realized. This risk is controlled by the System's investment guidelines and limited by periodic resets to the swap that allow the unrealized profit or loss to be realized. The market risk is equivalent to holding exposure to the index.

*Securities Lending.* Board of Trustees' policies permit the System to lend its securities to broker-dealers and other entities (borrowers) for collateral that will be returned for the same securities in the future. The System's custodian is the agent in lending the plan's domestic securities for collateral of 102 percent of fair value and international securities for collateral of 105 percent of fair value. The System changed custodians during fiscal 2002 and the securities lending program was moved to Mellon Global Securities Services as of the May 1, 2002 conversion date. The custodian receives cash or securities as collateral. All securities loans can be terminated on demand by either the System or the borrower. Cash collateral is invested in the lending agent's collective collateral investment pool, which at June 30, 2003 had a weighted-average maturity and duration of 18 days. At June 30, 2002 the cash collateral investment pool had a weighted-average maturity and duration of 27 days. The relationship between the maturities of the investment pool and the System's loans is affected by the maturities of securities loans made by other plan entities that invest cash collateral in the investment pool.

The System did not impose any restrictions during fiscal 2003 or 2002 on the amounts of loans the lending agent made on its behalf. The custodian provides full indemnification to the System for any losses that might occur in the program due to the failure of a broker/dealer to return a borrowed security or failure to pay the System for income earned on the securities while on loan. Securities on loan for securities collateral are classified in the following schedule of investments according to the category of the collateral received. Securities on loan at each year-end for cash collateral are unclassified as the cash collateral is invested in a collective collateral investment pool. At each year end, the System had no credit risk exposure to borrowers because the amounts the System owed the borrowers exceeded the amounts the borrowers owed the System.

## NOTES TO THE FINANCIAL STATEMENTS
(Continued)

As of June 30, 2003 and 2002, the market value of securities on loan were $112,111,173 and $74,910,313, respectively. Cash received as collateral and the related liabilities of $125,085,313 as of June 30, 2003 and $78,786,454 as of June 30, 2002 are shown on the Statements of Plan Net Assets. Securities received as collateral are not reported as assets since the System does not have the ability to pledge or sell the collateral absent borrower default.

*Categorization.* The System's investments are categorized to give an indication of the level of risk assumed by the System at year end. Category 1 includes investments that are insured or registered or for which the securities are held by the System or its agent in the System's name. Category 2 includes uninsured and unregistered investments for which the securities are held by a counterparty or its trust department or agent, but not in the System's name. All of the System's investments meet the criteria of category 1, except investments in mutual funds, a short-term investment fund, a short-term collateral investment pool and those securities on loan for which the cash collateral is invested in the collateral investment pool. These investments by their nature are not required to be categorized.

## NOTES TO THE FINANCIAL STATEMENTS

(Continued)

A schedule of investments as of June 30, 2003 and 2002 follows:

| | 2003 | 2002 |
|---|---|---|
| **Categorized Investments** | | |
| Short-term investments | | |
| Certificates of deposit | $22,000,000 | $2,000,329 |
| Time deposits | - | 5,000,000 |
| Repurchase agreements | 53,448,991 | 49,959,078 |
| Commercial paper | - | 76,864,913 |
| Corporate and other bonds | | |
| Not on securities loan | 9,432,246 | 9,521,869 |
| Asset-backed securities | | |
| Not on securities loan | 11,023,504 | 55,037,426 |
| U.S. Government bonds | 12,286,622 | 11,026,633 |
| Total Short-term investments | 108,191,363 | 209,410,248 |
| U.S. Government obligations | | |
| Not on securities loan | 9,017,376 | 13,982,574 |
| On securities loan for other collateral | 1,104,312 | 560,031 |
| Asset-backed securities | | |
| Not on securities loan | 135,147,680 | 214,864,850 |
| Corporate and other bonds | | |
| Not on securities loan | 161,254,811 | 139,744,715 |
| Common and preferred stock | | |
| Not on securities loan | 709,344,710 | 538,518,231 |
| On securities loan for other collateral | 159,262 | - |
| Total categorized investments | 1,124,219,514 | 1,117,080,649 |
| **Uncategorized Investments** | | |
| Mutual funds | 539,920,139 | 601,016,065 |
| Securities lending short-term collateral investment pool | 125,085,313 | 78,786,454 |
| Short-term investment fund | 349,388 | 919,459 |
| Investments held by broker-dealers under securities loans with cash collateral: | | |
| Short-term investments | 6,100,195 | - |
| U.S. Government obligations | 43,862,624 | 20,652,971 |
| Corporate and other bonds | 30,304,949 | 32,490,912 |
| Common and preferred stock | 28,164,140 | 14,570,828 |
| Asset-backed securities | 2,415,691 | 6,635,571 |
| Total uncategorized investments | 776,202,439 | 755,072,260 |
| **Total investments** | **$1,900,421,953** | **$1,872,152,909** |

### D. Income Taxes

The Internal Revenue Service issued a determination letter on February 23, 1995, which stated that the System and its underlying trust qualify under the applicable provisions of the Internal Revenue Code and therefore are exempt from federal income taxes. The System applied for an update of this ruling in a letter dated Nov. 26, 2002. In the opinion of the plan administrator, the System and its underlying trust have operated within the terms of the System and are qualified under the applicable provisions of the Internal Revenue Code.

## REQUIRED SUPPLEMENTARY INFORMATION

Six-year historical trend information about the System is presented here as required supplementary information. This information is intended to help users assess the System's funding status on a going-concern basis, assess progress made in accumulating assets to pay benefits when due, and make comparisons with other public employee retirement systems.

### SCHEDULE OF FUNDING PROGRESS

| Actuarial Valuation Date | Actuarial Value of Assets (a) | Actuarial Accrued Liability - AAL Entry Age (b) | Unfunded AAL- UAAL (b-a) | Funded Ratio (a/b) | Covered Payroll (c) | UAAL as a Percentage of Covered Payroll ((b-a)/c) |
|---|---|---|---|---|---|---|
| 7/1/97 | $1,231,382,638 | $1,241,813,772 | $10,431,134 | 99.16% | $365,583,822 | 2.85% |
| 7/1/98 | 1,324,132,857 | 1,334,468,657 | 10,335,800 | 99.23% | 381,220,936 | 2.71% |
| 7/1/99 | 1,523,310,967 | 1,467,043,776 | (56,267,191) | 103.84% | 399,732,318 | (14.08%) |
| 7/1/00 | 1,694,416,094 | 1,690,537,763 | (3,878,331) | 100.23% | 449,231,705 | (0.86%) |
| 7/1/01 | 1,807,813,497 | 1,857,801,915 | 49,988,418 | 97.31% | 476,327,250 | 10.49% |
| 7/1/02 | 1,854,088,532 | 2,051,677,465 | 197,588,933 | 90.37% | 507,905,310 | 38.90% |

Analysis of the dollar amounts of plan net assets, actuarial accrued liability, and unfunded actuarial accrued liability in isolation can be misleading. Expressing plan net assets as a percentage of the actuarial accrued liability 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 system. Trends in the unfunded actuarial accrued liability and annual covered payroll are both affected by inflation. Expressing the unfunded actuarial accrued liability 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, the smaller this percentage, the stronger the system.

### SCHEDULE OF EMPLOYER CONTRIBUTIONS

| Fiscal Year Ended June 30 | Annual Required Contribution | Percentage Contributed |
|---|---|---|
| 1998 | $30,955,140 | 100% |
| 1999 | 24,143,832 | 100% |
| 2000 | 27,133,595 | 100% |
| 2001 | 29,960,984 | 100% |
| 2002 | 31,083,805 | 100% |
| 2003 | 36,408,121 | 88% |

## NOTES TO REQUIRED SUPPLEMENTARY INFORMATION

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

| | |
|---|---|
| Valuation date | July 1, 2002 |
| Actuarial cost method | Entry age |
| Amortization method | Level percent closed |
| Remaining amortization period | Weighted average of 15 years |
| Asset valuation method | 3-Year smoothed market |
| Actuarial assumptions: | |
| Investment rate of return* | 7.5% |
| Projected salary increases* | 4.3%-5.4% |
| *Includes inflation at | 4.0% |
| Cost-of-living adjustments | 3.0% |

The actuarial assumptions used have been recommended by the actuary and adopted by the System's Board of Trustees based on the most recent review of the System's experience, completed in 2001.

The rate of employer contributions to the plan is composed of the normal cost, amortization of the unfunded actuarial accrued liability and an allowance for administrative expenses. The normal cost is a level percent of payroll cost which, along with the member contributions, will pay for projected benefits at retirement for the average plan participant. The actuarial accrued liability is that portion of the present value of projected benefits that will not be paid by future employer normal costs or member contributions. The difference between this liability and the funds accumulated as of the same date is the unfunded actuarial accrued liability. The allowance for administrative expenses is based upon the plan's actual administrative expenses.

Some effect of investment losses from fiscal 2001 and 2002 are impacting the employer contribution rate developed during the July 1, 2002 valuation. The impact of these losses resulted in the computation of a contribution rate of 9.26% for fiscal 2004, per the GASB methodology, an increase of 2.43% over the GASB computed rate of 6.83% for fiscal 2003. Beginning with fiscal 2003, the funding policy was revised to further stabilize the contribution rate. The methodology now in place sets the employer contribution rate equal to the normal cost and allowance for administrative expense. Amortization of the unfunded liability is included in the contribution rate only for benefit changes or if the actuarial funding ratio falls outside a corridor of 90% and 120%. Use of the corridor method results in an adopted rate of 6.13% for fiscal 2004, an increase of 0.13% over the fiscal 2003 adopted rate of 6.00%.

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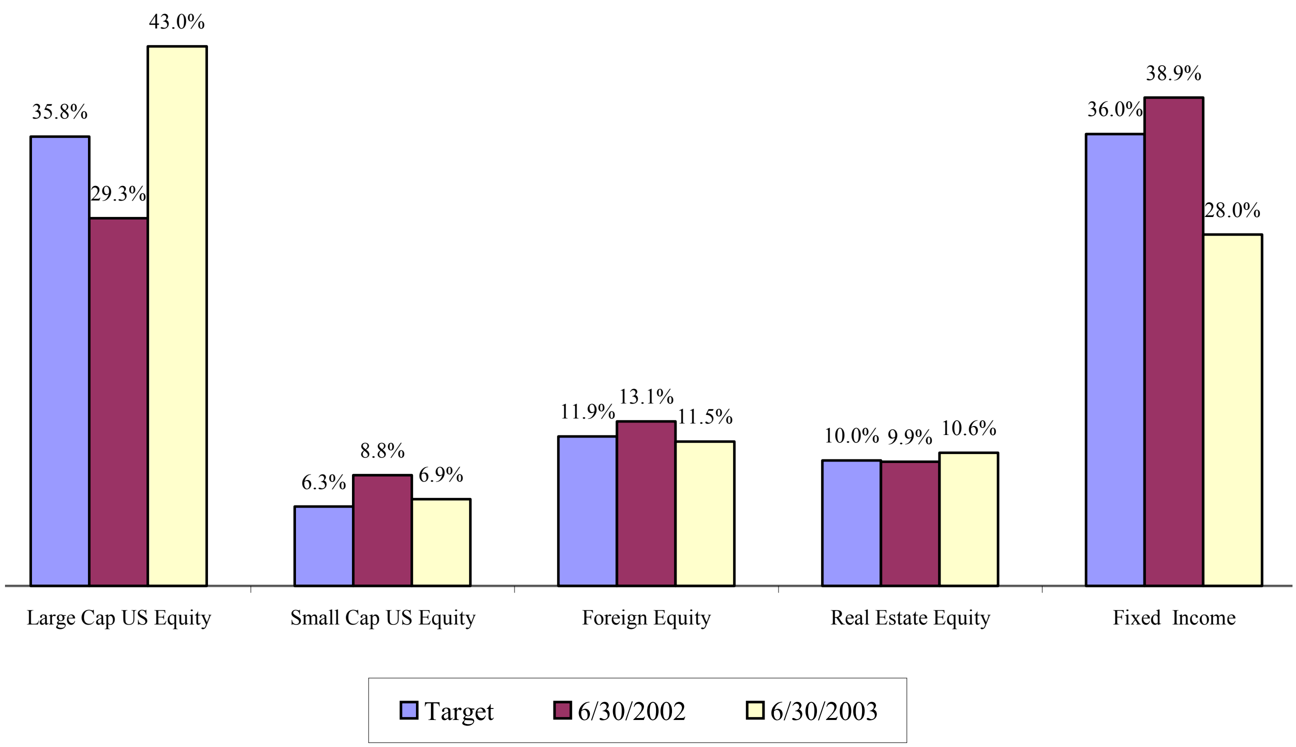
## OVERVIEW

The Board of Trustees has established an investment policy for the System to identify investment objectives, guidelines and performance standards for the assets of the System. The objectives are formulated in response to the anticipated needs of the System, the risk tolerance of the System and the desire of the Board of Trustees to define and fulfill their fiduciary responsibility over System assets.

The Board has established its asset class strategic target allocations which it believes will achieve the return requirements of the fund at an appropriate level of risk and maintain a comfortable risk tolerance. Further, a disciplined rebalancing policy was adopted to ensure that market movements do not cause asset class weightings to unintentionally stray too far from the target percentages. The actual asset allocation at market is reviewed weekly and if asset class weightings fall outside the "no rebalancing range", transfers between asset classes are initiated to rebalance the asset allocations to within the target ranges. In addition, a tactical asset allocation program is in place. As part of the tactical program, equities may be overweighted by up to 6%, as was the case at June 30, 2003. The following graph shows the target and actual asset allocations as of June 30, 2003 and 2002.

### Employees' Retirement System Target Allocation and Actual Asset Class Exposure




The Board of Trustees hires investment management firms and provides each firm with a mandate, and benchmark index or a blend of indices against which the performance of the account is measured. Each managed account has its own investment guidelines outlining the nature of the investments to be held in the account and detailing allowed and/or prohibited transactions. Investment managers are requested to submit a written statement describing their proposed investment strategy and tactics for achieving the investment goals and objectives that are required by their guidelines. Investment manager performance is monitored by staff and reviewed by the Board of Trustees quarterly.

## CAPITAL MARKETS AND ECONOMIC CONDITIONS

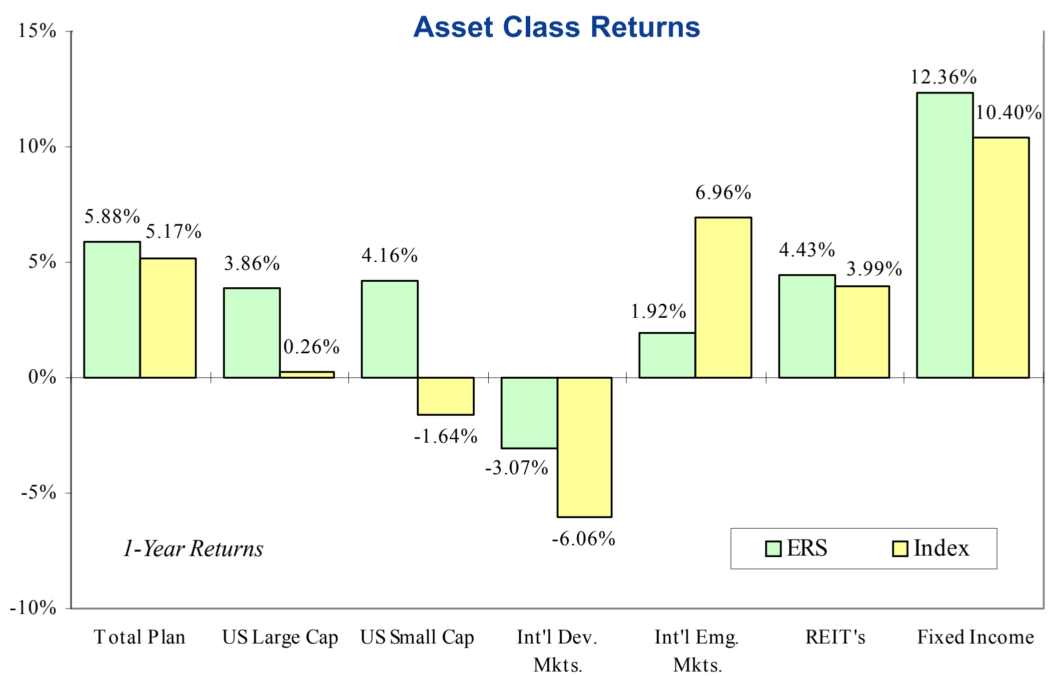
### Financial and Economic Summary

Fiscal year 2003 experienced a third-consecutive tumultuous and disappointing year for equity markets. After sharp declines of 14.8% in fiscal 2001 and 18.0% in 2002, during which investors lost $6 trillion, the S&P 500 Index broke even in fiscal 2003 with a meager gain of +0.3%. The S&P 500 went on a roller coaster ride in 2003. The fiscal first quarter was down sharply, followed by a recovery in the second quarter, leading to a decline in the third quarter, before finishing with a strong rebound in the fourth quarter.

The fiscal year began in July of 2002 with one of the worst quarters in history and the very poorest for equities since the fourth quarter of 1987. The US was not alone in its suffering. Equity markets world-wide fell sharply as investors bailed out of equities in the face of geopolitical uncertainty, corporate accounting scandals, declining corporate earnings and sluggish economic progress. By the end of the fiscal first quarter, the S&P 500 Index had lost 17.3% and had given up a cumulative 42% of its value since the turn of the century.

As the second fiscal quarter began, the S&P 500 plummeted to a 5-year low on October 9th, which in hindsight would prove to be the low point of the year. From that point equities began a rally which carried the index up 27.1% through the end of June 2003. The rally was not enough however, to keep the S&P 500 Index on December 31, 2002 from posting its third-consecutive calendar down year, the first time since the Great Depression for three negative years in a row.

The third quarter of fiscal 2003 was dominated by the war in Iraq. During the first two months of the year, uncertainty regarding the start and duration of a military campaign in Iraq stalled US equity markets. Even after war commenced, investor reaction to news from embedded reporters overshadowed economic indicators and negative profit warnings. When the US appeared to gain quick control of the conflict, the S&P 500 staged an 8-day rally in mid-March, before giving back most of the gains at quarter's end. During this quarter personal consumption expenditures declined as consumer confidence hit a 10-year low and GDP growth decelerated. The S&P 500 Index fell 3.2% for the quarter.



## CAPITAL MARKETS AND ECONOMIC CONDITIONS
(Continued)

Improving corporate financials, aggressive fiscal and monetary stimulus measures from the federal government, and the military progress in Iraq sparked a fiscal fourth-quarter stock and bond market rally around the world. Economic indicators started showing generally positive trends, but unemployment rose to 6.4% at fiscal year end, the highest rate in nine years. Real GDP grew 3.3%, fueled by continued consumer spending, while business investment fell and inventories increased slightly. The mainstay of economic recovery during the past 12 months was autos and housing, each a beneficiary of the extraordinarily low interest rates. Equity indexes officially crossed into bull-market territory during this quarter, bringing an end to the longest and worst bear market (S&P 500 down 47.4%) of the post-World War II era. As a result of all this new-found optimism, the S&P 500 Index advanced 15.4%, the best quarterly return in five years, while the small cap stock index advanced 23.4%, a 12-year best.

For the full year, the best performing asset class was high-yield bonds (+26.4%), followed by international bonds (+17.4%), investment grade bonds (+10.4%), then emerging markets equities (+7.0%) and public real estate securities (+4.0%). Mid-cap stocks, up 2.6% for the year, outperformed large-cap stocks by 2.2 percentage points and small-cap equities by 4.2 percentage points. This marked the fourth year in a row that mid-cap stocks had bested large-cap stocks. Within the Russell 3000, growth outperformed value by 4.0 percentage points, although style leadership flip-flopped between value and growth in each of the four quarters. Health Care (+8.5%) was the best performing industry sector during fiscal 2003, followed by Technology (6.4%). The Transportation (-15.3%) and Energy (-8.0%) sectors had the greatest negative impact on S&P 500 performance.

The US economy proved to be the engine driving world economies in fiscal 2003. Equity markets worldwide followed the dynamics of the US markets. Developed market stock prices, as evidenced by the MSCI EAFE Index, declined 6.1% as governments tried to stimulate growth in a sluggish environment and faced with a declining US dollar. Asian market returns were dampened by the outbreak of the SARS epidemic, which was estimated to have clipped 1% - 2% off of GDP in that region. Emerging markets fared better, gaining 7.0% for the year, led by a strong rebound in Latin America.

Fixed income investors realized gains in every quarter of the year, as yields fell and corporate spreads widened. Bond yields in the US fell to 45-year lows and to record lows in Europe and Japan, led by monetary easing amid sluggish growth and low inflation. Inflation remained mild as the Consumer Price Index increased only 2.1% year-over-year. In June, the Federal Reserve lowered the fed funds rate for the thirteenth time since the downturn began. At that point, short-term interest rates stood at 1.0%, the lowest rate since 1958. The Lehman Brothers Aggregate Bond Index returned a stellar 10.4% for the fiscal year. The two best performing sub-sectors were Treasury bonds (+11.9%) and high-yield corporates (+26.4%), reflecting a flight to quality in the case of Treasuries and the stretching for yield by investors in the case of the high-yield sector. The worst performing bond sector was mortgage-backed securities, which returned only 1.6% due to fears of early mortgage pre-payment.

Global bonds continued their strong run, rising some 17% for the year in dollar terms. Declining global interest rates lifted non-US bond prices, but the major contributor to out-performance was the falling US dollar, especially against the Euro.

Real estate exhibited a fascinating conundrum. Starved for income in an environment of 1% - 2% returns on short-term securities, investors bid up real estate prices to gain the income yield during a period when real estate fundamentals were actually declining.

## CAPITAL MARKETS AND ECONOMIC CONDITIONS

(Continued)

### System

The Employees' Retirement System operates a sound and diversified investment program with disciplined asset re-balancing to achieve strategic long-term goals. The disciplined investment process has been effective in achieving a long-term record of consistent asset growth.

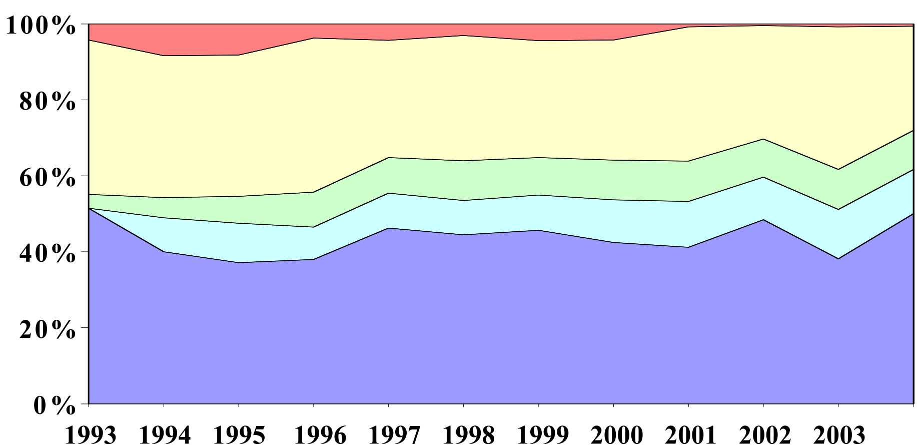
### Compound Annual Return on Investment Portfolio

| 1 Year | 3 Years | 5 Years | 10 Years |
|---|---|---|---|
| 5.88% | 0.52% | 3.28% | 8.77% |

*Returns are gross of expenses*

On a market value basis, the total net assets held in trust rose from $1,716.9 million at June 30, 2002 to $1,780.1 million at June 30, 2003. For fiscal 2003, investments provided a return of +5.6%, net of fees, reflecting an improving economic environment. The System's annualized rate of return, net of fees, was +0.2% over the last three years and +3.0% over the last five years. While these investment returns were less than targeted in an absolute sense, the System's return ranked in the top quartile of a universe of public plan sponsors during fiscal 2003, was in the top third of public funds in 2002, and was in the top quartile in fiscal 2001. The Employees' Retirement System's annualized net return over the last five years has trailed the rate of 7.5%, the long-term return used for actuarial purposes. At year-end 2003, the System's assets were allocated by manager mandate as follows: domestic and international equities – 61.4%; fixed income securities – 27.9%; and real estate – 10.7%.

### Asset Allocation 1993 - 2003



## ASSET ALLOCATION BY CATEGORY AND INVESTMENT MANAGER

June 30, 2003

| Asset Class Manager | Investment Style | Total Assets | % of Total Net Assets |
|---|---|---|---|
| ***Domestic Equities*** | | | |
| Trust Company of the West | Active Large Cap Growth | $ 138,878,505 | 7.8% |
| DSI | Enhanced Large Cap Index | 138,865,002 | 7.8% |
| Acorn Fund* | Active Small Cap Core | 124,251,457 | 7.0% |
| Robert E. Torray | Active Large Cap Value | 122,042,518 | 6.9% |
| BGI Equity Value Fund* | Large Cap Value Index | 95,857,964 | 5.4% |
| BGI Equity Growth Fund* | Large Cap Growth Index | 73,806,891 | 4.1% |
| Thomson Horstmann & Bryant | Active Small Cap Value | 42,146,476 | 2.4% |
| JP Morgan US Smartindex* | Enhanced Large Cap Core | 39,488,261 | 2.2% |
| ***International Equities*** | | | |
| Lazard Asset Management | Active Developed Markets | 121,778,528 | 6.8% |
| BGI Emerging Markets Fund* | Passive Emerging Markets | 58,544,374 | 3.3% |
| ***Real Estate*** | | | |
| Cohen & Steers | Active Equity REITs | 191,547,524 | 10.7% |
| ***Core Fixed Income*** | | | |
| Trust Company of the West | Strategic Mortgage-backed | 104,524,306 | 5.9% |
| Bridgewater TIPS | Treasury Inflation Protected | 98,500,816 | 5.5% |
| JP Morgan Fleming* | Investment-grade Core | 96,749,868 | 5.4% |
| Peregrine Capital | Active Domestic Duration | 93,522,094 | 5.3% |
| Brandywine | Active International | 57,503,251 | 3.2% |
| ***High Yield Fixed Income*** | | | |
| MW Post | High Yield | 47,879,377 | 2.7% |
| MacKay Shields | High Yield | 47,048,487 | 2.6% |
| Shenkman | High Yield | 42,970,511 | 2.4% |
| ***Short-term*** | | | |
| Standish Mellon Enhanced STIF - Fund portion | Active Short-term | 41,743,422 | 2.3% |
| Cash Held at County Treasurer | Active Short-term | 5,280,277 | 0.3% |
| ***Net Assets*** ** | | **$ 1,782,929,909** | **100.0%** |

** Pooled Fund*

*** Without deduction for accounts payable and accrued liabilities.*

## LIST OF LARGEST HOLDINGS FOR ACTIVE (Non-Pooled) ACCOUNTS

June 30, 2003

| Asset Class / Manager / Security | Market Value | % of Account |
|---|---|---|
| ***Domestic Equities*** | | |
| Trust Company of the West | | |
| Progressive Corp | $12,723,786 | 9.16% |
| Genentech Inc. | $10,060,740 | 7.25% |
| Amazon.com Inc. | $8,764,016 | 6.31% |
| Amgen Inc. | $8,268,876 | 5.96% |
| Network Appliance Inc. | $6,854,904 | 4.94% |
| DSI Enhanced Index | | |
| General Electric Co. | $4,562,988 | 3.29% |
| Microsoft Corp. | $4,399,824 | 3.17% |
| Pfizer Inc. | $4,370,859 | 3.15% |
| Wal Mart Stores Inc. | $3,751,533 | 2.70% |
| Exxon Mobil Corp. | $3,745,413 | 2.70% |
| Robert E. Torray | | |
| Clear Channel Communications | $5,341,140 | 4.38% |
| United Technologies Corp. | $5,283,918 | 4.33% |
| J.P. Morgan Chase & Co. | $5,246,972 | 4.30% |
| Illinois Tool Works Inc. | $5,116,545 | 4.20% |
| Abbott Labs | $5,115,544 | 4.20% |
| Thomson Horstmann & Bryant | | |
| Hudson United Bancorp | $737,503 | 1.75% |
| Dime Community Bancorp Inc. | $695,583 | 1.65% |
| PFF Bancorp Inc. | $691,835 | 1.64% |
| Ann Taylor Stores Corp | $660,060 | 1.57% |
| Patterson Dental Co. | $653,760 | 1.55% |
| ***International Equities*** | | |
| Lazard Asset Management | | |
| Vodafone Group PLC | $4,534,246 | 3.74% |
| HSBC Holdings | $4,400,111 | 3.63% |
| Royal Dutch Petroleum Co. | $4,270,300 | 3.52% |
| Glaxosmithkline | $4,234,044 | 3.49% |
| Total SA | $3,853,633 | 3.18% |
| ***Real Estate*** | | |
| Cohen & Steers | | |
| Vornado Realty Trust | $13,119,240 | 6.92% |
| Boston Properties Inc. | $10,963,140 | 5.79% |
| Equity Office Properties Trust | $10,207,079 | 5.39% |
| Simon Property Group Inc. | $9,133,020 | 4.82% |
| Rouse Co. | $8,903,970 | 4.70% |

| Asset Class<br>Manager<br>Security | Market Value | % of Account |
|---|---|---|
| ***Core Fixed Income*** | | |
| Trust Company of the West | | |
| FHLMC, 8% , 5/15/2030 | $7,036,460 | 6.43% |
| GNMA REMIC, Variable rate, 11/20/2031 | $6,891,999 | 6.30% |
| FHLMC, 7.5%, 6/15/2030 | $6,627,819 | 6.06% |
| Master Asset Security, 5.55% , 7/1/2033 | $6,069,375 | 5.55% |
| FHLMC, 5.0%, 4/15/2033 | $5,873,924 | 5.37% |
| Bridgewater TIPS | | |
| US Treas Inflation Index Note, 3.625, 1/15/2008 | $16,716,750 | 17.12% |
| US Treas Inflation Index Note, 3.375%, 1/15/2007 | $15,795,657 | 16.17% |
| US Treas Inflation Index Note, 3.00%, 7/15/2012 | $6,308,226 | 6.46% |
| US Treas Inflation Index Bond, 3.625%, 4/15/2028 | $3,043,620 | 3.12% |
| US Treas Inflation Index Note, 3.875%, 1/15/2009 | $1,543,285 | 1.58% |
| Peregrine Capital | | |
| FNMA Note, 2.030%, 4/28/2005 | $7,027,714 | 7.54% |
| SLMA Note, 2.050%, 4/25/2005 | $7,026,455 | 7.54% |
| SLMA Note, 2.125% , 4/25/2005 | $7,006,132 | 7.52% |
| FNMA Note, 2.150%, 1/28,2005 | $6,506,504 | 6.98% |
| FNMA Note, 2.010%, 5/5/2005 | $6,274,909 | 6.74% |
| Brandywine Asset Management | | |
| Republic of Italy Bond, 4.00%, 7/15/2005 | $7,255,712 | 12.90% |
| Bundesrepublik Deutschland Bond, 5.25%, 7/4/2010 | $6,267,979 | 11.15% |
| New Zealand Government Bond, 6.00%, 11/15/2011 | $5,156,245 | 9.17% |
| Fed Republic of Germany Bond, 4.50%, 7/4/2009 | $5,120,270 | 9.11% |
| Kingdom of Sweden Bond, 5.00%, 1/28/2009 | $4,159,199 | 7.40% |
| ***High Yield Fixed income*** | | |
| MW Post | | |
| AAI Pharma Inc., 11.00%, 4/1/2010 | $1,760,000 | 3.77% |
| Carmike Cinemas Inc., 10.375%, 2/1/2009 | $1,575,000 | 3.37% |
| Qwest Services Corp. 144A 13.50%, 12/15/2010 | $1,498,380 | 3.21% |
| PG&E Gas Transit NW, 7.80%, 6/1/2005 | $1,402,500 | 3.00% |
| Horseshoe Gaming LLC, 8.625% 5/15/2009 | $1,325,000 | 2.84% |
| MacKay Shields | | |
| Calpine Canada Energy, 8.50%, 5/1/2008 | $702,000 | 1.51% |
| El Paso Energy - Cedar Brakes, 9.875%, 9/1/2013 | $617,707 | 1.33% |
| Columbia/HCA Healthcare, 7.50%, 11/15/2095 | $601,262 | 1.29% |
| Colt Telecom Group PLC 144A Conv, 2.00%, 4/3/2007 | $544,223 | 1.17% |
| DJ Orthopedics LLC, 12.625%,6/15/2009 | $540,000 | 1.16% |
| Shenkman Capital Mgt. | | |
| Dex Media East LLC, 12.125%, 11/15/2012 | $827,750 | 1.96% |
| Sinclair Broadcast Group Inc., 8.75%, 12/15/2011 | $823,125 | 1.94% |
| American Achievement Corp., 11.625%, 1/1/2007 | $802,500 | 1.90% |
| Emmis Broadcasting Corp., 8.125%, 3/15/2009 | $785,625 | 1.86% |
| Westport Resources Corp., 8.25%, 11/1/2011 | $602,250 | 1.42% |

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A MILLIMAN GLOBAL FIRM

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May 2, 2003

Fairfax County Employees'
Retirement System
10680 Main Street, Suite 280
Fairfax, Virginia 22030-3812

Dear Members of the Board:

At your request, we have conducted our annual actuarial valuation of the Fairfax County Employees' Retirement System as of July 1, 2002. The results of the valuation are contained in the following report. The purpose of this valuation is discussed in the Board Summary.

***Funding Objective***

The funding objective of the System for Fiscal Year 2003 is to establish contribution rates which, over time, will remain level as a percent of payroll. In order to achieve this, a contribution rate has been determined which will provide for current cost (i.e., normal cost expressed as a level percent of payroll) plus level percent of payroll amortizations of each layer of the unfunded liability over a 15 year period. This funding objective is currently being realized.

The system changed the funding objective for Fiscal Year 2004. We describe the revised funding objective in the Actuary's Comments section.

***Assumptions***

The actuarial assumptions used in performing this valuation have been recommended by the actuary and adopted by the Board of Trustees based on Milliman's most recent review of the System's experience (from July 1, 1995 to June 30, 2000). We believe the assumptions used, in the aggregate, reflect our best estimate of anticipated future experience of the plan. The results of this report are dependent upon future experience conforming to these assumptions. To the extent that future experience deviates from these assumptions, the true cost of the plan could vary from our results. Since the prior valuation there have been only minor changes to plan features which did not materially impact the overall contribution rate for the System. However, as will be discussed in the Actuary's Comments section, there were changes in experience and actuarial methods and procedures that will significantly impact the System's contribution rate for Fiscal Year 2004.

The assumptions and methods used in performing this valuation meet the parameters set by The Governmental Accounting Standards Board (GASB) Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans.*

Fairfax County Employees' Retirement System
Page 2

***Reliance on Others***
In preparing our report we relied, without audit, on information (some oral and some written) supplied by the System's staff. This information includes, but is not limited to, Plan provisions, employee data, and financial information. Census data provided to us has been reviewed for reasonableness, and for consistency with prior year's data.

***Supporting Schedules***
We were responsible for all supporting schedules to be found in the Actuarial Section.

We were responsible for all years of the Schedule of Funding Progress, Schedule of Employer Contributions and Notes to Required Supplementary Information shown in the Financial Section.

***Compliance with Code of Virginia §51.1-800***
Code of Virginia 51.1-800 requires that the benefits provided to a retiree at age 65 from a local retirement system equal or exceed two-thirds of the allowance to which the employee would be entitled under the provisions of the Virginia Retirement System (VRS). The Board of Trustees of the VRS is to determine whether a local system satisfies this condition, taking into account differences in member contributions between the local system and the VRS.

Although there is no formal procedure for making this comparison, we have compared the least valuable rate under the Employees' Plan to the most valuable accrual rate under the VRS, making adjustments for the fact that employee contributions are required in excess of the VRS 5% rate. The employer provided accrual rates do exceed two-thirds of the employer provided accrual rates under the VRS plan.

We certify that, to the best of our knowledge and understanding, the Fairfax County Employees' Retirement System satisfies the requirements of the Code of Virginia 51.1-800.

***Certification***
I, Robert Dezube and I, John C. Muehl, are consulting actuaries for Milliman, USA. We are also members of the American Academy of Actuaries and meet their Qualification Standards to render the actuarial opinion contained herein.

We hereby certify that, to the best of our knowledge, this report is complete and accurate and has been prepared in accordance with generally recognized and accepted actuarial principles and practices which are consistent with the applicable Guides to Professional Conduct, amplifying Opinions, and supporting Recommendations and Interpretations of the American Academy of Actuaries.

Sincerely,

Milliman USA

John C. Muehl

John C. Muehl, FSA
Consulting Actuary

Robert Dezube

Robert S. Dezube, FSA
Consulting Actuary

MILLIMAN USA

## SUMMARY OF VALUATION RESULTS

### Overview

This report presents the results of the July 1, 2002 actuarial valuation of the Fairfax County Employees' Retirement System. The primary purposes of performing the annual actuarial valuation are to:

- determine the contributions to be paid by the County in fiscal year 2004;
- measure and disclose, as of the valuation date, the financial condition of the System;
- indicate trends in the financial progress of the System;
- provide specific information and documentation required by the Governmental Accounting Standards Board (GASB).

This section of the report presents a summary of the above information in the form of:

- the actuary's comments;
- the prior year's experience of the System's assets, liabilities, contributions, and membership;
- a series of graphs which highlight key trends experienced by the System; and
- a summary of all the principal results from this year's valuation, compared to the prior year's, in a single table, intended for quick reference purposes.

### Actuary's Comments

The System had an investment return of negative 4.17% for the year, considerably below the 7.5% assumption. This was a significant factor leading to an unfunded liability of $197.6 million as of July 1, 2002. This compares to a $50.0 million unfunded liability measured as of July 1, 2001. In relative terms, the funding ratio (assets divided by liabilities) fell from 97.3% to 90.4%.

This marks the third consecutive period of unfavorable market return (less than the 7.5% assumption). Therefore, the impact on the actuarial, or smoothed, value of assets is more significant without the help of stored gains as in prior years. On this smoothed basis, the System earned 3.69%, nearly 4% less than our assumption. This resulted in an investment loss of $68.6 million. Combined with a liability loss of $70.9 million, the System experienced a total actuarial loss of $139.5 million.

This report reflects a significant change to the way the System determines the employer contribution rate. The Board of Supervisors approved the use of a corridor method to fund the System. Under this funding approach, the County's contribution rate is equal to the normal cost rate plus expense rate determined as of the implementation date of the corridor method (July 1, 2001). This rate will remain the same as long as the System's actuarial funded status remains within a corridor of 90% to 120%. The County's contribution rate will change due to changes in benefits. The new rate will reflect the change in normal cost rate and 15 year funding of the change in actuarial accrued liability. The normal cost rate and actuarial accrued liability will continue to be measured using the entry age funding method. If the funded status falls outside the corridor a credit (if above 120%) or charge (if below 90%) will be established based on a 15-year amortization equal to the amount necessary to re-enter the corridor. Once the funded status is within the corridor the contribution rate will return to the normal cost rate plus expense rate.

## SUMMARY OF VALUATION RESULTS
(Continued)

The plan was amended to grant an ad hoc COLA of 1.00% to all retirees effective July 1, 2002.

The results of this valuation report disclose the actuarially determined rate, which will be used for purposes of disclosing the Annual Required Contribution rate under Governmental Accounting Standards Board Statement No. 25 (GASB #25). The analysis in this report will focus on the actuarially determined rate, but will footnote the resulting contribution rate from the corridor method.

Finally, while the results are not on the favorable side this year, we emphasize again that financing a retirement system is a long-term proposition. Annual fluctuations are to be expected and should not by themselves be causes for concern. In our opinion the System's overall financial condition is healthy and there are procedures, assumptions and methods in place which adequately and appropriately finance the emerging long-term liabilities of the System.

The balance of this section summarizes System trends and provides the principal details on this year's experience.

### Prior Year Experience

**ASSETS**

Plan assets for this System are measured on both a market value and an actuarial value basis. The actuarial value is established by phasing in investment experience outside of the actuarial assumptions at a rate of 33-1/3% per year. In periods of high return, this method significantly limits the amount of asset gain which is recognized, or conversely, the amount of asset loss recognized when returns are abnormally low. The advantage of this approach is that costs are more stable over time. The plan does not feel the full immediate impact of lower (or higher) costs when assets increase (or decrease) dramatically.

For the plan year ending June 30, 2002, the System earned negative 4.17% on a market value basis, and 3.69% on an actuarial value basis. The return, on both a market and actuarial basis, was lower than the assumption of 7.5%, which produces a loss (when compared to the expected growth using the 7.5% assumption) to the System of $210.2 million (market value), and a loss of $68.6 million (actuarial value). The specific changes between the prior year amounts and this year's are presented below.

| Item | Market Value | Actuarial Value |
|---|---|---|
| July 1, 2001 value | $ 1,811,980,376 | $ 1,807,813,497 |
| Employer Contributions | 31,083,805 | 31,083,805 |
| Member Contributions | 24,217,436 | 24,217,436 |
| Benefit Payments and Expenses | (75,286,299) | (75,286,299) |
| Expected investment earnings (7.5%) | 135,149,089 | 134,836,573 |
| Expected value July 1, 2002 | 1,927,144,407 | 1,922,665,012 |
| Investment gain (loss) | (210,208,836) | (68,576,480) |
| **July 1, 2002 value** | **$ 1,716,935,571** | **$ 1,854,088,532** |

## SUMMARY OF VALUATION RESULTS
(Continued)

### LIABILITIES

Three different measures of liabilities are calculated for this System: a total value of future obligations, an actuarial liability, and an accounting liability. Each type of liability is distinguished by the people ultimately using the figures, and the purpose for which they are using them.

Total future obligations liability is used for analyzing the financial outlook of the System. This represents the amount of money needed today to fully pay off all future benefits and expenses of the System, assuming participants continue to accrue benefits.

Actuarial liability is used for funding calculations and GASB disclosures. Taking the total future obligations and subtracting the present value of future member contributions and future employer normal costs under an acceptable actuarial funding method calculate this liability. The entry age normal funding method is used.

Accrued liability is used for communicating the current level of liabilities. This liability represents the total amount of money needed today to fully pay off the current accrued obligations of the System, assuming no future accruals of benefits. This liability is required for accounting purposes under statement No. 35 of the Financial Accounting Standards Board.

Only the actuarial liability is analyzed in terms of a gain or loss experience, which then is used to determine the System's funding and GASB disclosures. During the plan year ending in 2002, the actuarial liabilities experienced a loss of $70.9 million, which is 3.5% of the total actuarial liability being measured. The liability loss was due to including an additional group of employees, retirement occurring earlier than expected, pay increases in excess of those expected, and other less significant sources. We will continue to monitor gains and losses to ensure there is no significant pattern.

| Liabilities | Total Value | Actuarial | Accounting |
|---|---|---|---|
| July 1, 2001 | $ 2,256,019,656 | $ 1,857,801,915 | $ 1,400,981,333 |
| July 1, 2002 | $ 2,465,170,493 | $ 2,051,677,465 | $ 1,567,199,910 |

### UNFUNDED LIABILITIES AND FUNDING RATIOS

The difference between assets and liabilities is the unfunded liability. This is measured in two ways: unfunded actuarial liabilities, which compare the actuarial liabilities to the actuarial asset value, and unfunded accrued benefits, which compare the accounting liability to the market value of assets. These amounts are shown for July 1, 2001 and July 1, 2002, as well as the corresponding funded ratios for each (assets divided by liabilities).

| Unfunded Liabilities | Actuarial | Accounting |
|---|---|---|
| Net (Surplus) Unfunded July 1, 2001 | $ 49,988,418 | $ (410,999,043) |
| Funded Ratio | 97.3% | 129.3% |
| Net (Surplus) Unfunded July 1, 2002 | $ 197,588,933 | $ (149,735,661) |
| Funded Ratio | 90.4% | 109.6% |

## SUMMARY OF VALUATION RESULTS
(Continued)

### CONTRIBUTIONS

This summary presents the County contribution rate and compares it to the rate developed in the July 1, 2001 actuarial valuation. Due to the net impact of investment and liability losses, the County contribution rate, payable in FY 2004 on the GASB disclosure basis increased by 2.43% of payroll. It is important to note that this is not the contribution rate that the County has adopted in either FY 2003 or FY 2004. The Corridor Funding Method produces contribution rates of 6.00% in the July 1, 2001 valuation, (for fiscal 2003), increasing to 6.13% as of July 1, 2002 (for fiscal 2004).

**Rate as a Percent of Covered Payroll - GASB Disclosure**

| | |
|---|---|
| July 1, 2001 valuation; FY 2003 contribution rate | 6.83% |
| Increase due to Ad-Hoc COLA | 0.13% |
| Increase due to investment loss (gain) | 1.13% |
| Increase due to liability loss (gain) | 1.17% |
| July 1, 2002 valuation rate; FY 2004 contribution rate* | 9.26% |

*For 2002 this represents a fresh start to a 15-year amortization period.

**Rate as a Percent of Covered Payroll - Corridor Method**

| | |
|---|---|
| July 1, 2001 valuation; FY 2003 contribution rate | 6.00% |
| Increase due to Ad-Hoc COLA | 0.13% |
| July 1, 2002 valuation rate; FY 2004 contribution rate* | 6.13% |

### MEMBERSHIP

There are three types of plan participants: current active workers, terminated workers who retain a right to a deferred vested benefit, and retirees and beneficiaries receiving benefits. Below are totals for each group as of July 1, 2002 and 2001.

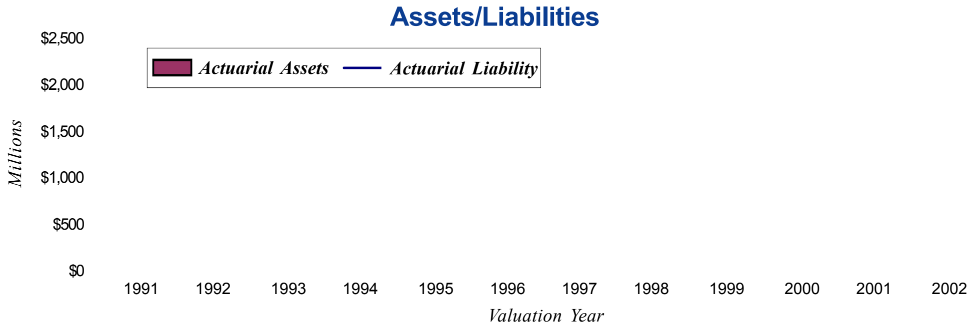
There was an overall increase in participation during the year.

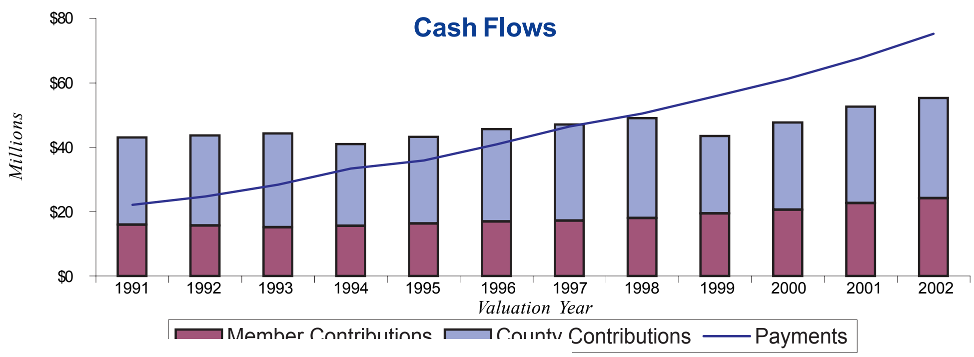
| | 7/1/2002 | 7/1/2001 | Change |
|---|---|---|---|
| Active participants | 14,185 | 13,849 | 2.4% |
| Terminated vested participants | 413 | 409 | 1.0% |
| Retirees and beneficiaries receiving benefits | 4,164 | 3,974 | 4.8% |
| Total participants | 18,762 | 18,232 | 2.9% |

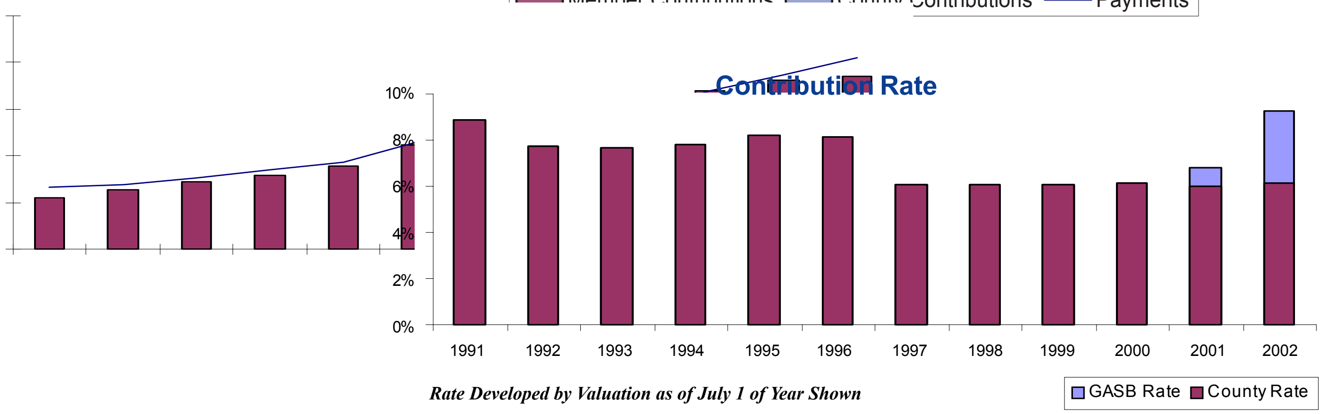
## Trends

To truly understand the financial condition of the pension plan, a review of the prior years' funded status is helpful in seeing the big picture and general trend evolving. Below are three charts which present trend information from 1991 through the end of 2002. Comments on each chart follow.

## SUMMARY OF VALUATION RESULTS
(Continued)




### COMMENTS

The asset/liability chart places into perspective the aforementioned investment and liability performance losses of this past year.

The cash flows chart presents an emerging trend that will have investment implications. It is a trend being faced by many public retirement systems, with the aging of our baby boomer generation. Payments to retirees are on the increase, while cash into the fund, from employer and employee contributions is stable or declining. Another significant contributing factor is the increasing ratio of retirees to actives, which is due to the stabilization of the active workforce. This is anticipated and essentially explains the need to build up assets in the System.

The contributions chart shows the fluctuation in the County contribution rate and the impact of the Corridor Method of determining the County contributions.

## SUMMARY OF VALUATION RESULTS
(Continued)

### SUMMARY OF PRINCIPAL RESULTS

This table compares the principal results from the 2002 and 2001 valuations.

| Participant Data | July 1, 2002 | July 1, 2001 | Percent Change |
|---|---|---|---|
| Number of: | | | |
| Active members | 14,185 | 13,849 | 2.4% |
| Retired members and beneficiaries | 4,164 | 3,974 | 4.8% |
| Vested former members | 413 | 409 | 1.0% |
| Annual salaries of active members | $512,416,475 | $ 487,075,596 | 5.2% |
| Annual benefits for retired members, and beneficiaries | $64,294,052 | $57,900,750 | 11.0% |

| Assets and Liabilities | July 1, 2002 | July 1, 2001 | Percent Change |
|---|---|---|---|
| Total actuarial liability | $2,051,677,465 | $ 1,857,801,915 | 10.4% |
| Assets for valuation purposes | 1,854,088,532 | 1,807,813,497 | 2.6% |
| Unfunded actuarial liability | 197,588,933 | 49,988,418 | 295.3% |
| Funded ratio | 90.4% | 97.3% | N/A |
| Present value of accrued benefits | $1,567,199,910 | $ 1,400,981,333 | 11.9% |
| Market value of assets | 1,716,935,571 | 1,811,980,376 | - 5.2% |
| Unfunded FASB accrued liability | (149,735,661) | (410,999,043) | -63.6% |
| Accrued benefit funding ratio | 109.6% | 129.3% | N/A |

| Contributions *(as percent of payroll)* | Fiscal Year 2004 | Fiscal Year 2003 |
|---|---|---|
| **GASB Method:** | | |
| Employer normal cost rate | 5.85% | 5.85% |
| Unfunded actuarial liability contribution | 3.26% | 0.83% |
| Administrative expense | 0.15% | 0.15% |
| Total employer contribution - GASB method | 9.26% | 6.83% |
| **Corridor Method:** | | |
| Employer normal cost rate | 5.85% | 5.85% |
| Increase due to ad-hoc COLA | 0.13% | 0.00% |
| Administrative expense | 0.15% | 0.15% |
| Total employer contribution - corridor method | 6.13% | 6.00% |

## SUMMARY OF ACTUARIAL ASSUMPTIONS AND METHODS

### Funding Method

The funding method used for this valuation is the “aggregate accrual modification of the entry age normal cost method.” Under this method, the employer contribution has three components - the normal cost, the payment toward the unfunded actuarial liability, and the expense rate.

The normal cost is a level percent of pay cost which, along with the member contributions, will pay for projected benefits at retirement for the average plan participant. The level percent developed is called the normal cost rate and the product of that rate and payroll is the normal cost.

The actuarial liability is that portion of the present value of projected benefits that will not be paid by future employer normal costs or member contributions. The difference between this liability and funds accumulated as of the same date is referred to as the unfunded actuarial liability.

The expense rate is added to cover the System’s administrative expenses.

### Actuarial Value of Assets

For purposes of determining the County contribution to the plan we use an actuarial value of assets. The asset adjustment smoothing method dampens the volatility in asset values that could occur because of fluctuations in market conditions. Use of an asset smoothing method is consistent with the long term nature of the actuarial valuation process.

In determining the actuarial value of assets, we calculate an expected actuarial value based on cash flow for the year and imputed returns at the actuarial assumption. This expected value is compared to the market value and one-third of the difference is added to the preliminary actuarial value to arrive at the final actuarial value.

### Changes Since Last Valuation

There have been no changes since the last valuation.

## ACTUARIAL ASSUMPTIONS AND METHODS

**Long Term Assumptions Used to Determine System Costs and Liabilities**

### Demographic Assumptions

#### Mortality

**1994 Uninsured Pensioners Mortality Table**
**Annual Deaths Per 1,000 Members***

| Age | Male Deaths | Female Deaths | Age | Male Deaths | Female Deaths |
|---|---|---|---|---|---|
| 20 | 1 | 0 | 65 | 16 | 9 |
| 25 | 1 | 0 | 70 | 26 | 15 |
| 30 | 1 | 0 | 75 | 40 | 24 |
| 35 | 1 | 1 | 80 | 67 | 42 |
| 40 | 1 | 1 | 85 | 105 | 73 |
| 45 | 2 | 1 | 90 | 164 | 125 |
| 50 | 3 | 2 | 95 | 251 | 200 |
| 55 | 5 | 2 | 100 | 341 | 297 |
| 60 | 9 | 5 | 105 | 441 | 415 |

*5% of deaths are assumed to be service-connected.

**Termination of Employment:** (Prior to Normal Retirement Eligibility)

**Annual Terminations per 1,000 Members - Male**
**Years of Employment with County**

| Age | 0-1 | 1-2 | 2-3 | 3-4 | 4-5 | 5 or more |
|---|---|---|---|---|---|---|
| 20 | 150 | 150 | 150 | 191 | 174 | 80 |
| 25 | 150 | 150 | 150 | 165 | 150 | 80 |
| 30 | 150 | 150 | 150 | 135 | 122 | 66 |
| 35 | 150 | 150 | 150 | 114 | 103 | 53 |
| 40 | 150 | 150 | 150 | 99 | 89 | 42 |
| 45 | 150 | 150 | 150 | 86 | 78 | 37 |
| 50 | 150 | 150 | 150 | 77 | 69 | 33 |
| 55 | 150 | 150 | 150 | 69 | 64 | 29 |

## ACTUARIAL ASSUMPTIONS AND METHODS

(Continued)

**Termination of Employment:** (Prior to Normal Retirement Eligibility) Continued

**Annual Terminations per 1,000 members - Female**
**Years of Employment with County**

| Age | 0-1 | 1-2 | 2-3 | 3-4 | 4-5 | 5 or more |
|---|---|---|---|---|---|---|
| 20 | 200 | 200 | 200 | 158 | 150 | 132 |
| 25 | 200 | 200 | 200 | 158 | 150 | 120 |
| 30 | 200 | 200 | 200 | 158 | 150 | 102 |
| 35 | 200 | 200 | 200 | 158 | 150 | 85 |
| 40 | 200 | 200 | 200 | 158 | 150 | 70 |
| 45 | 200 | 200 | 200 | 158 | 150 | 58 |
| 50 | 200 | 200 | 200 | 158 | 150 | 50 |
| 55 | 200 | 200 | 200 | 158 | 150 | 40 |

It is assumed that members who terminated before normal or early retirement age elect to receive a refund of contributions instead of vested benefits.

### Disability

| Annual Disabilities per 10,000 Members* | | | Annual Deaths per 1,000 Disabled Members | | |
|---|---|---|---|---|---|
| Age | Male | Female | Age | Male | Female |
| 25 | 4 | 4 | 45 | 43 | 24 |
| 30 | 4 | 4 | 50 | 48 | 28 |
| 35 | 6 | 4 | 55 | 53 | 33 |
| 40 | 9 | 7 | 60 | 58 | 38 |
| 45 | 23 | 18 | 65 | 64 | 44 |
| 50 | 41 | 33 | 70 | 73 | 51 |
| 55 | 64 | 51 | 75 | 89 | 63 |
| 60 | 64 | 51 | 80 | 107 | 80 |

*30% of disabilities are assumed to be service-connected. Of these, 5% are assumed to receive Social Security benefits and 31% are assumed to receive Workers Compensation benefits.

## ACTUARIAL ASSUMPTIONS AND METHODS
(Continued)

### Retirement

**Annual retirements per 1,000 eligible members (male and female) who are eligible for unreduced benefits** (age 65 with 5 years of service or age 50 with age plus service equal to at least 80).

| Age | First Year | Thereafter | Age | First Year | Thereafter |
|---|---|---|---|---|---|
| 50 | 400 | N/A | | | |
| 51 | 400 | 200 | 61 | 250 | 200 |
| 52 | 400 | 200 | 62 | 250 | 200 |
| 53 | 400 | 200 | 63 | 250 | 200 |
| 54 | 400 | 200 | 64 | 250 | 200 |
| 55 | 400 | 200 | 65 | 250 | 333 |
| 56 | 250 | 200 | 66 | 250 | 250 |
| 57 | 250 | 200 | 67 | 250 | 250 |
| 58 | 250 | 200 | 68 | 250 | 250 |
| 59 | 250 | 200 | 69 | 250 | 250 |
| 60 | 250 | 200 | 70 | 1,000 | 1,000 |

**Merit/Seniority Salary Increase** (in addition to across-the-board increase)

| Age | Merit/Seniority Increase |
|---|---|
| 25 | 0.5% |
| 30 | 0.5% |
| 35 | 0.5% |
| 40 | 0.5% |
| 45 | 0.5% |
| 50 | 0.5% |
| 55 | 0.5% |

## ACTUARIAL ASSUMPTIONS AND METHODS
(Continued)

### Family Composition

For purposes of valuing the pre-retirement death benefit, an assumption is made concerning how many employees are married is needed. The assumption used in this valuation is that 80% of employees are married at death while active and that the female spouse is 3 years younger than the male spouse.

### Sick Leave Credit

It is assumed that retirees, deferred vested terminations, and deceased members receive an additional 1.5% of service credit due to sick leave.

### Economic Assumptions

**Investment Return:** 7.50% compounded per annum.

**Rate of General Wage Increase:** 4.00% compounded per annum.

**Rate of Increase in Cost-of-Living:** 4.00% compounded per annum.
(Benefit increases limited to 4% per year. Post-retirement cost-of-living increases are assumed to be 3% per year.)

**Total Payroll Increase (for amortization):** 4.00% compounded per annum.

**Administrative Expenses:** 0.15% of payroll.

### Changes Since Last Valuation

There have been no changes since the last valuation.

## ANALYSIS OF FINANCIAL EXPERIENCE

### Gain and Loss in Accrued Liability During Years Ended June 30
### Resulting from Differences Between Assumed Experience and Actual Experience

| Type of Activity | 1999 | 2000 | 2001 | 2002 |
|---|---|---|---|---|
| Investment income | $ 112,549,118 | $ 71,003,374 | $ 2,083,439 | ($68,576,480) |
| Combined liability experience | (40,178,389) | (62,256,683) | (25,622,128) | (70,933,718) |
| Gain (or loss) during year from financial experience | $ 72,370,729 | $ 8,746,691 | ($23,538,689) | ($139,510,198) |
| Non-recurring items | (5,662,558) | (62,469,217) | (30,509,256) | (7,877,508) |
| Composite gain (or loss) during year | **$ 66,708,171** | **($53,722,526)** | **($54,047,945)** | **($147,387,706)** |

## SCHEDULE OF RETIREES AND BENEFICIARIES ADDED TO AND REMOVED FROM ROLLS

| | Added to Rolls | | Removed From Rolls | | On Rolls @ Yr. End | | | |
|---|---|---|---|---|---|---|---|---|
| Year Ended June 30 | No. | Annual Allowance | No. | Annual Allowance | No. | Annual Allowance | % Increase Allowance | Average Allowance |
| 1997 | 302 | $5,683,056 | 86 | $1,210,797 | 3,157 | $42,582,030 | 11.74% | $13,488 |
| 1998 | 302 | 5,971,265 | 98 | 1,459,487 | 3,361 | 47,093,808 | 10.60% | 14,012 |
| 1999 | 334 | 7,658,527 | 105 | 1,831,976 | 3,590 | 52,920,359 | 12.37% | 14,741 |
| 2000 | 285 | 7,669,426 | 118 | 1,807,023 | 3,757 | 58,782,762 | 11.08% | 15,646 |
| 2001 | 353 | 9,384,327 | 136 | 1,544,051 | 3,974 | 66,623,038 | 13.34% | 16,765 |
| 2002 | 298 | 9,541,544 | 108 | 1,129,459 | 4,164 | 74,945,123 | 12.49% | 17,998 |

## SOLVENCY TEST

### Aggregate Accrued Liabilities For

| Valuation Date | (1) Active Member Contributions | (2) Retirees Vested Terms, Beneficiaries | (3) Active Members (Employer Financed Portion) | Reported Assets | Portion of Accrued Liabilities Covered by Reported Assets (1) | (2) | (3) |
|---|---|---|---|---|---|---|---|
| 7/1/97 | $156,795,828 | $475,446,920 | $609,571,024 | $1,231,382,638 | 100% | 100% | 98% |
| 7/1/98 | 166,884,229 | 523,288,834 | 644,295,594 | 1,324,132,857 | 100% | 100% | 98% |
| 7/1/99 | 177,466,940 | 591,682,196 | 697,894,630 | 1,523,310,967 | 100% | 100% | 108% |
| 7/1/00 | 189,751,068 | 671,715,760 | 829,070,935 | 1,694,416,094 | 100% | 100% | 100% |
| 7/1/01 | 194,412,262 | 731,698,653 | 931,691,000 | 1,807,813,497 | 100% | 100% | 95% |
| 7/1/02 | 207,072,630 | 820,951,804 | 1,023,653,031 | 1,854,088,532 | 100% | 100% | 81% |

## SCHEDULE OF ADDITIONS BY SOURCE

| Fiscal Year | Plan Member Contributions | Employer Contributions | Employer Contributions % of Covered Payroll | Net Investment Income (loss) | Total Additions |
|---|---|---|---|---|---|
| 1998 | $ 17,996,500 | $ 30,955,140 | 8.12% | $ 238,318,868 | $ 287,270,508 |
| 1999 | 19,413,441 | 24,143,832 | 6.04% | 137,594,536 | 181,151,809 |
| 2000 | 20,561,280 | 27,133,595 | 6.04% | 101,648,889 | 149,343,764 |
| 2001 | 22,553,731 | 29,960,984 | 6.29% | (9,245,125) | 43,269,590 |
| 2002 | 24,217,436 | 31,083,805 | 6.12% | (75,059,747) | (19,758,506) |
| 2003 | 25,467,082 | 31,983,708 | 6.00% | 89,440,289 | 146,891,079 |

## SCHEDULE OF DEDUCTIONS BY TYPE

| Fiscal Year | Benefit Payments | Refunds of Contributions | Administrative Expenses | Total Deductions |
|---|---|---|---|---|
| 1998 | $ 44,966,835 | $ 4,898,119 | $ 586,152 | $ 50,451,106 |
| 1999 | 50,754,184 | 4,404,218 | 621,495 | 55,779,897 |
| 2000 | 55,452,114 | 5,123,873 | 754,136 | 61,330,123 |
| 2001 | 62,431,928 | 4,503,567 | 776,563 | 67,712,058 |
| 2002 | 70,703,829 | 3,774,942 | 807,528 | 75,286,299 |
| 2003 | 79,442,355 | 3,425,017 | 845,537 | 83,712,909 |

## SCHEDULE OF BENEFIT PAYMENTS BY TYPE

| Fiscal Year Ended June 30 | Annuity | Service-Connected Disability | Ordinary Disability | Survivor | Total |
|---|---|---|---|---|---|
| 1998 | $39,494,011 | $2,134,493 | $2,207,808 | $1,130,523 | $44,966,835 |
| 1999 | 44,877,010 | 2,270,671 | 2,352,826 | 1,253,677 | 50,754,184 |
| 2000 | 49,250,201 | 2,430,337 | 2,403,449 | 1,368,127 | 55,452,114 |
| 2001 | 55,890,164 | 2,469,474 | 2,503,087 | 1,569,203 | 62,431,928 |
| 2002 | 63,723,688 | 2,553,198 | 2,738,462 | 1,688,480 | 70,703,828 |
| 2003 | 71,933,909 | 2,634,434 | 2,918,607 | 1,955,406 | 79,442,356 |

## SCHEDULE OF RETIRED MEMBERS BY BENEFIT TYPE

| Fiscal Year Ended June 30 | Annuity | Service-Connected Disability | Ordinary Disability | Survivor | Total |
|---|---|---|---|---|---|
| 1998 | 2,713 | 165 | 354 | 129 | 3,361 |
| 1999 | 2,914 | 176 | 363 | 137 | 3,590 |
| 2000 | 3,075 | 175 | 360 | 147 | 3,757 |
| 2001 | 3,274 | 176 | 361 | 163 | 3,974 |
| 2002 | 3,459 | 174 | 366 | 165 | 4,164 |
| 2003 | 3,674 | 172 | 364 | 178 | 4,388 |

## SCHEDULE OF AVERAGE MONTHLY BENEFIT AMOUNTS

| Fiscal Year Ended June 30 | Annuity | Service-Connected Disability | Ordinary Disability | Survivor | Average |
|---|---|---|---|---|---|
| 1998 | $1,274 | $1,104 | $528 | $773 | $1,168 |
| 1999 | 1,341 | 1,122 | 539 | 804 | 1,229 |
| 2000 | 1,420 | 1,173 | 568 | 838 | 1,304 |
| 2001 | 1,521 | 1,223 | 593 | 886 | 1,397 |
| 2002 | 1,629 | 1,223 | 680 | 879 | 1,506 |
| 2003 | 1,750 | 1,326 | 687 | 886 | 1,610 |