

## 2007 Supplemental Budget Information

Prepared for the House Appropriations Committee





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February 16, 2007

Members of the House Appropriations Committee

Dear Members:

On behalf of the State Employees' Retirement System, I am pleased to provide you with the following supplemental information, which we believe may be helpful to you in your budget deliberations.

We are pleased to report, as detailed at Tab 8, that SERS recorded another year of outstanding investment performance in 2006. With a net return of 16.4%, the system earned more than \$4.5 billion on its investments. SERS' 16.4% return is nearly double the system's 8.5% actuarially assumed rate of return, and a full two percentage points better than the 14.3% median return for large public funds

This marks the fourth consecutive year of stellar returns, once again in placing SERS' annual performance among the top 25% of large public pension plans nationwide. SERS also ranks among the top quartile for long-term performance: Over the past decade, and despite the historic bear market, SERS' investments have produced a net compounded annualized return of 10.2% per year.

I also would direct your attention to Tab 7, Funding Process and Actuarial Status. Here we report on the plan's current status, which at 92.9% funded is far superior to the 80% average funding level of major state pension plans nationwide.

In Tab 7, we also address what we know is the central concern of policymakers: The need to confront the employer funding obligation that was deferred by Act 2003-40, resulting in a projected spike in employer contribution rates in 2012. The 2012 spike (now projected at 15.1%) would be followed by an extended period of above-normal employer rates in subsequent years. Those high long-term rates are a direct (and avoidable) consequence of Act 40, which is severely suppressing rates in the near term. Indeed, because SERS' investment returns have been so unexpectedly strong, the Act 40 amortization schedule will deprive SERS of any employer contributions for the four years prior to 2012.

Options exist, as explained in TAB 7, to reduce or even eliminate the 2012 spike, and also greatly reduce rates in subsequent years. This could be accomplished by maintaining some level of employer funding through the four-year period when Act 40 is now expected to drive rates to zero.

SERS stands ready to work with the Legislature as you seek the most feasible means, in light of other budget obligations, to moderate or even eliminate the rate spike.

Additional tabs offer information on, among other topics, member services and demographics, Pennsylvania investments and the Commonwealth's Deferred Compensation Program, which the SERS Board also administers.

If you have any questions regarding any of the information in this booklet, please contact Executive Director Eric Henry. Thank you in advance for your consideration of SERS 2006-07 budget request.

Sincerely,

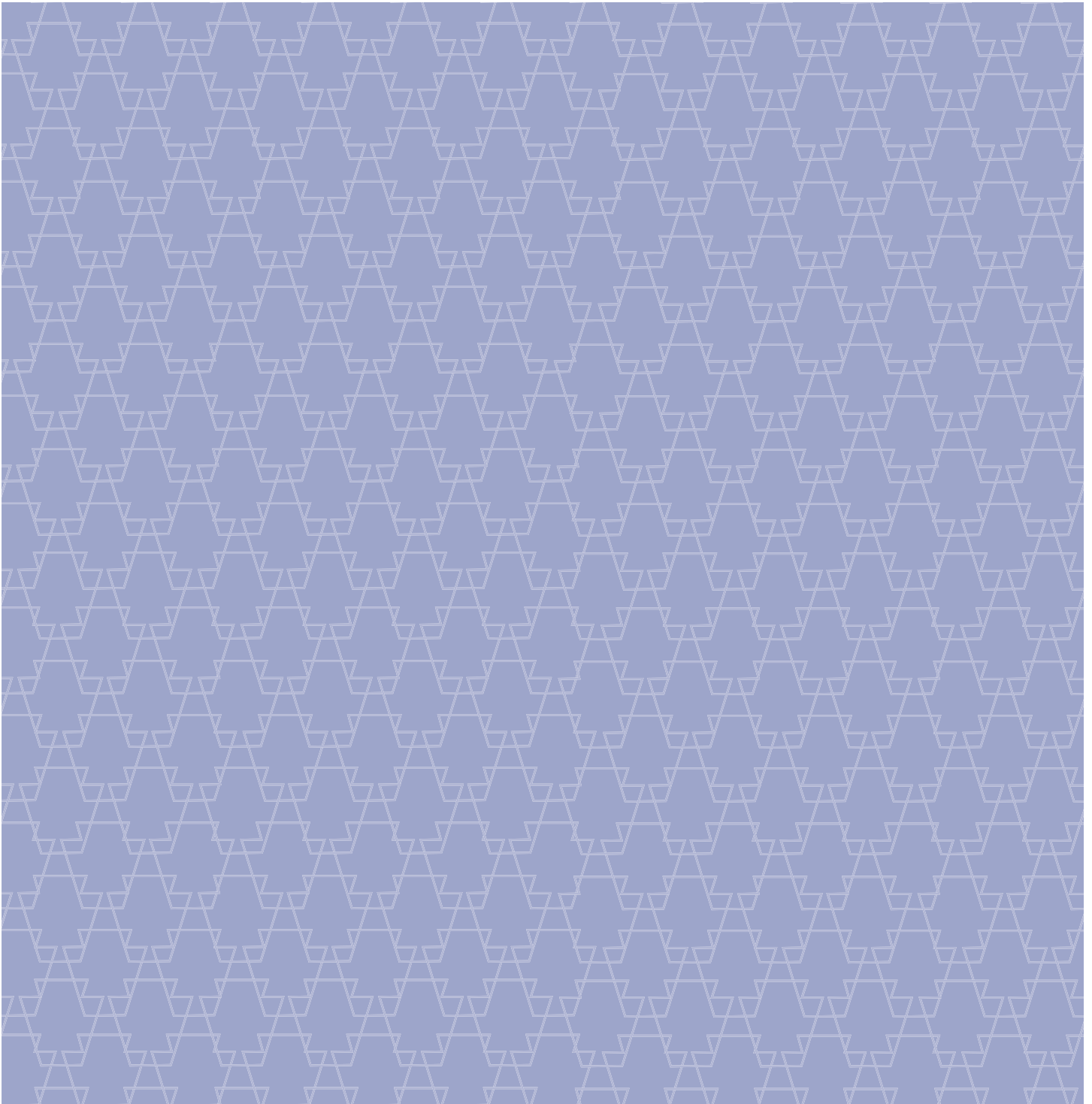
Nicholas J. Maiale  
Chairman

Attachment

# Table of Contents

Organizational Overview	Tab 1
2007-2008 Budget -- Board Submission	Tab 2
Investment Advisory and Consultant Fees	Tab 3
Directed Commissions	Tab 4
Member Services and Demographics	Tab 5
Legislation	Tab 6
Funding Process and Actuarial Status	Tab 7
Investment Policy, Objectives and Performance	Tab 8
Investment Program Summary	Tab 9
Pennsylvania Investments Summary	Tab 10
Women/Minority Advisors and Brokers	Tab 11
Deferred Compensation Program	Tab 12

# Organizational Overview



# Mission, Vision & Guiding Principles

Established in 1923, the Pennsylvania State Employees' Retirement System (SERS) is one of the nation's oldest and largest statewide retirement plans for public employees, with more than 200,000 members. SERS is among the largest of public and corporate pension funds, with assets of approximately \$32.1 billion as of December 31, 2006.

SERS is responsible for administering the State Employees' Retirement Code in accordance with the expressed intent of the General Assembly and bears a fiduciary obligation to the state employees and retirees who are the plan beneficiaries.

State law provides that the administration of the SERS fund and the fiduciary responsibility for its management be vested in an 11-member Board. The management of SERS is the responsibility of the Executive Director who, with the approval of the Board, contracts for professional services and employs the staff needed to operate the system. The SERS Fund is administered under a Mission and Vision.

## Mission

The mission of SERS is to provide retirement benefits and services to our members through sound administration and prudent investments.

## Vision

By 2010, SERS will be prepared for operational, financial, and public policy impacts of the Baby Boom generation while providing retirement benefits and services.

## Guiding Principles

- Demonstrate Integrity
- Think Strategically
- Lead Innovation and Improvement
- Develop and Empower Employees
- Share Knowledge
- Focus on Customer Service
- Learn from Mistakes
- Safeguard Information, Facilities and Staff
- Fulfill Fiduciary Obligations

# Organization & Operations

The agency's various program functions are administered by staff in SERS' Harrisburg Central Office and through a statewide network of seven Regional Retirement Counseling Centers. Assignment of major agency functions is as follows:

**Executive Office:** Supports the Executive Director who is the agency's senior staff administrator. Provides direct service to the Chairman of the SERS Board and Board members. Makes arrangements for and conducts administrative functions for all Board meetings. Conducts research and provides agency direction on organizational development, strategic planning, pending retirement issues and actuarial considerations. Includes the **Communications and Policy Office**, which serves a variety of communication-related support functions. These include preparation and dissemination of retirement-related information and publications, tracking and reporting on retirement legislation, and handling inquiries from the media, state Legislature and the public.

**Office of Finance and Administration:** Provides the accounting structure for SERS' \$32.1 billion Fund; oversees all transactions, including payment of member benefits, purchase and sale of investment securities, receipt of employer and employee contributions and investment income, and administration of the agency operational budget. The office also manages agency operations and disaster recovery planning, while reporting to the SERS Board on management of the approximately \$1.7 billion Commonwealth Deferred Compensation Program.

**Investment Office:** Working closely with the SERS Board, this office monitors the management of Fund assets and determines investment policy for directing the allocation of Fund resources. The office works in tandem with the Fund's outside investment managers and consultants, performs research on investment products and investment managers, and recommends an investment program for review/approval by the Board.

**Legal Office:** Provides counsel to the SERS Board and the agency, including handling administrative hearings involving SERS members, reviewing investment and non-investment-related contracts, and providing legal advice.

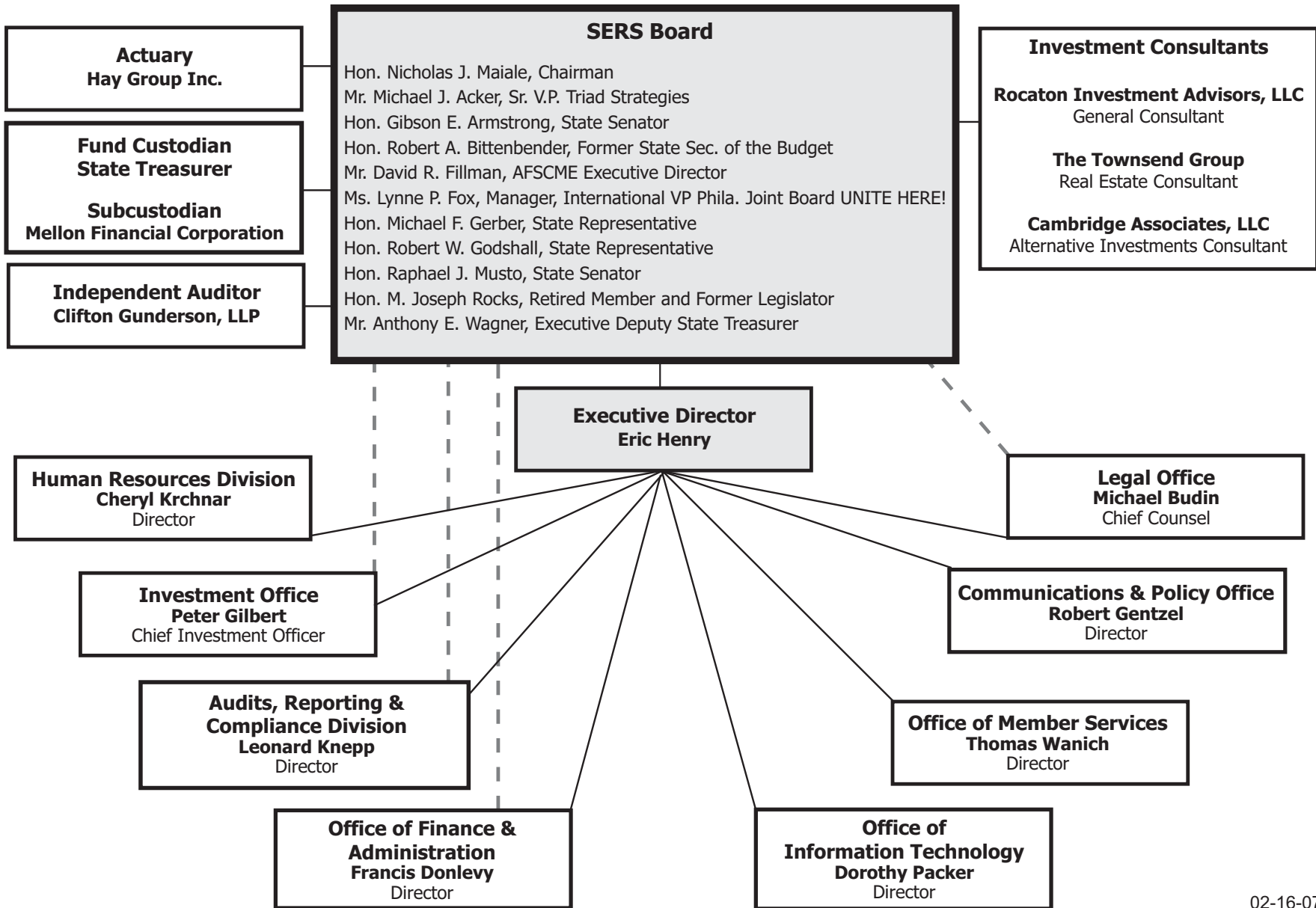
**Audits, Reporting and Compliance Division:** Provides the Board with the assurance that internal controls are adequate and operating as designed through internal audits of business processes. Coordinates audits performed at SERS by external agencies and auditors. Prepares agency financial and investment reports, performs analysis and compliance reviews of investments and other programs.

**Human Resources Division:** Responsible for management and development of human resources.

**Office of Information Technology:** Provides all computer and technical support for SERS operations, including a Wide Area Network linking the agency's seven Regional Retirement Counseling Centers.

**Office of Member Services:** Provides individualized counseling and retirement-related seminars through SERS' statewide system of seven Regional Retirement Counseling Centers. Processes member and member-survivor benefit payments and provides membership account services. Researches issues in public pension programs, recommends adoption of new strategies, and performs special retirement-related functions.

# SERS Organizational Chart



02-16-07



## 2007-2008 Budget -- Board Submission





# SERS Budget 2007-2008

	Budget 2003-04	Budget 2004-05	Budget 2005-06	Budget 2006-07	Budget Request 2007-08
<b>Personnel Services</b>	<b>\$13,604,877</b>	<b>\$13,797,455</b>	<b>\$14,374,963</b>	<b>\$15,600,000</b>	<b>\$16,299,000</b>
<b>Operational Expenses:</b>					
Travel	254,300	187,860	225,713	230,000	221,000
Training	129,175	119,080	219,985	204,700	189,000
Telecommunications Recurring	333,325	269,640	272,530	279,800	345,800
Telecommunications Non-Recurring	950	1,800	11,700	5,100	1,500
Consultant-Non-EDP	640,705	2,513,832	3,718,437	2,795,000	2,953,000
Legal Services/Fees	60,000	131,896	95,775	90,000	50,000
Specialized Services	490,469	1,120,935	990,805	1,369,000	1,512,000
Relocation	-	-	-	-	15,000
Advertising	2,150	-	-	-	3,500
Contracted EDP Services-Vendor Provided	1,525,475	1,653,881	554,576	781,000	1,365,900
Contracted Maintenance Services-EDP	161,100	81,680	86,850	105,500	138,500
Contracted Maintenance-Non-EDP	22,180	24,065	25,475	17,700	34,300
Contracted Repairs-Non-EDP	3,000	-	-	-	4,500
Contracted Repairs-Motorized Equipment	2,150	855	805	-	-
EDP	958,482	841,304	1,103,446	1,145,500	908,600
Real Estate	1,417,753	1,490,784	1,491,553	1,500,000	1,545,000
Vehicles	62,450	71,050	82,900	84,700	72,500
Office Equipment	-	-	-	23,100	34,500
Other Rentals/Leases	125,959	118,235	103,860	133,000	139,300
Office Supplies	259,600	743,144	420,406	121,000	62,300
Educational Supplies	4,100	2,680	1,900	1,100	1,000
Other Computer Equipment	-	-	-	346,000	369,500
Furniture/Fixtures	-	-	-	-	90,500
Motorized Equipment	5,900	5,860	9,600	6,600	6,200
Postage	416,900	420,365	434,321	235,500	315,000
Freight	8,100	10,600	7,000	5,000	7,400
Printing	156,250	184,720	239,550	169,000	209,700
Subscriptions	13,200	15,285	19,645	20,000	31,500
Membership Dues	47,500	47,750	57,280	60,000	58,400
Conference Expenses	7,250	6,750	20,050	45,000	18,500
Purchasing Card Purchases	222,700	273,494	195,975	208,400	210,000
Insurance, Surety, & Fidelity Bonds	5,000	5,000	5,000	5,300	5,000
Other Operational Expenses	775,000	200,000	326,900	268,000	280,100
<b>Total Operational</b>	<b>8,111,123</b>	<b>10,542,545</b>	<b>10,722,037</b>	<b>10,255,000</b>	<b>11,199,000</b>
<b>Fixed Assets</b>	<b>446,000</b>	<b>150,000</b>	<b>90,000</b>	<b>70,000</b>	<b>70,000</b>
<b>Total Budget</b>	<b>\$22,162,000</b>	<b>\$24,490,000</b>	<b>\$25,187,000</b>	<b>\$25,925,000</b>	<b>\$27,568,000</b>



## Investment Advisory and Consultant Fees



# Investment Advisory & Consultant Fees

Calendar Year 2006

## Advisory Fees

<b>Asset Class</b>	<b>Fees (in \$)<sup>1/</sup></b>	<b>Fees<sup>2/</sup> (in basis points)</b>
Equities	\$141,968,138	83.5
Fixed Income	19,687,017	42.3
Real Estate	22,948,549	91.3
Alternative Investments	94,682,659	122.8
Inflation Protection	7,466,040	35.6
<b>Total Fund</b>	<b>\$286,752,403</b>	<b>83.5</b>

<sup>1/</sup> Fees paid and accrued by SERS during the period from January 1, 2006, through December 31, 2006, according to SERS records maintained by the Office of Finance and Administration (OFA).

<sup>2/</sup> The fee data from OFA was divided by the SERS total fund and asset class average values during calendar year 2006 to arrive at the basis point calculations. Alternative Investments were determined based on committed capital during the active investment stage of the partnership, and on market value during the maturity stage of the partnership to most accurately reflect the calculation of fees for those management services.

## Average Basis Points Calendar Years Ended 2002-2006

<b>Calendar Year</b>	<b>Fees (\$ mil)</b>	<b>Basis Points</b>
2002	153.7	58.4
2003	184.4	65.9
2004	195.1	66.3
2005	231.2	78.4
2006	286.8	83.5

## 2006 Consultant Fees

<b>Firm</b>	<b>Status</b>	<b>Fees</b>
Cambridge Associates	Alternative Investments	\$1,083,333
Rocaton Investment Advisors	General	446,667
The Hay Group, Inc.	General	308,920
Independent Fiduciary Services	General	268,500
The Townsend Group	Real Estate	224,050
Institutional Shareholders Services	General	103,125

# Fees to Managers (Non-Budget Appropriation)

SERS employs outside investment managers. Active management by private-sector investment professionals has generated returns, after fees, that exceed passive benchmarks. In 2006, SERS earned 16.4 percent, or more than \$4.5 billion, on its investment portfolio, performance that placed it among the top 25 percent of all large public pension funds nationwide. The following agreements related to the management of the SERS investment portfolio are paid through a non-budget appropriation. They are treated as a reduction of the investment revenue of the fund rather than as a direct administrative expense.

**2006**

## Domestic Equity

AQR Capital Management	Greenwich	CT	10,385,143
Artemis Investment Management	New York	NY	1,460
AXA Rosenberg Investment Management LLC	Orinda	CA	1,710,516
Barclays Global Investors, N.A. - Alpha Tilt	San Francisco	CA	1,278,759
Barclays Global Investors, N.A. - Index Fund P	San Francisco	CA	67,068
Blackstone Alternative Asset Management	New York	NY	17,396,539
Bridgewater Associates PA#1	Westport	CT	9,943,598
Bridgewater Associates PA#2	Westport	CT	1,906,525
Emerald Advisers Inc.	Lancaster	PA	1,143,626
First Quadrant, L.P.	Pasadena	CA	356,987
Iridian Asset Management, LLC	Westport	CT	1,658,555
Martingale Asset Management, L.P.	Boston	MA	431,782
Mellon Equity Associates, LLP (PA Fund)	Pittsburgh	PA	313,927
Mellon Equity Associates, LLP (Special Portfolio)	Pittsburgh	PA	467
Mesirow Advanced Strategies	Chicago	IL	11,208,547
Morgan Stanley Alternative Investments Partners, L.P.	West Conshohocken	PA	6,731,398
MSAIP (Domestic Equitization Program)	West Conshohocken	PA	668,703
NISA Beta-Overlay	St. Louis	MO	388,586
OFI Institutional Asset Management	Bellefonte	PA	4,604
Pacific Alternative Asset Management	Irvine	CA	12,175,864
Provident Investment Counsel, Inc.	Pasadena	CA	1,101
The Boston Company Asset Management, LLC	Boston	MA	534,925
Twin Capital Management, Inc.	McMurray	PA	344,200

## Inflation Protection

NISA Investment Advisors, LLC	St. Louis	MO	2,131,724
Wellington	Boston	MA	5,334,316

## International Equity

Arden Asset Management	New York	NY	1,300,000
Artisan Partners Limited Partnership	Milwaukee	WI	2,990,969
Bernstein Emerging Markets	New York	NY	1,316,816
GAM International Management, Ltd.	New York	NY	836,722
Harris Associates L.P.	Chicago	IL	2,877,685
J. P. Morgan Investment Management, Inc.	New York	NY	1,216,320
Marathon Asset Management, Ltd.	London	UK	2,366,373
Merrill Lynch Investment Managers	New York	NY	2,847,666

## Fees to Managers *(International Equity, continued)*

Morgan Stanley, Dean Witter Inv. Mgt., Inc. - Asia ex. Japan	New York	NY	601,417
Morgan Stanley, Dean Witter Investment Mgt., Inc. - EAFE	London	UK	3,120,536
Oaktree Cap. Mgt, LLC - Emerging Mkt. Feeder Fund (2003)	Los Angeles	CA	6,992,826
Pictet International Management, Ltd. (Emerging Markets)	London	UK	1,316,502
Pictet International Management, Ltd. (Small Cap)	London	UK	1,276,196
Rexiter Emerging Markets	Boston	MA	1,114,039
Rock Creek Group	Washington, DC		1,300,000
Templeton Investment Counsel, LLC	Fort Lauderdale	FL	2,192,768
Templeton Strategic Emerging Market Fund	Fort Lauderdale	FL	18,240,060
Templeton Strategic Emerging Market Fund II	Fort Lauderdale	FL	2,000,000
Templeton TIFI - Emerging Markets Series	Fort Lauderdale	FL	4,553,341
Walter Scott & Partners Limited	Edinburgh		1,104,535

### Currency Overlay

Pareto Partners	New York	NY	1,607,014
Record Treasury Management, Ltd.	Berkshire	UK	1,281,144

### Global Equity

Marathon-Europe EQ Global	London	UK	215,211
Walter Scott & Partners Global	Edinburgh	Scotland	647,117

### Fixed Income

Ashmore Emerging Market	London	UK	1,800,613
Ashmore Local Currency	London	UK	1,156,675
Berwind Financial Group, Inc.	Philadelphia	PA	164,612
Fidelity Management & Research Co.	Boston	MA	1,901,090
Goldman Sachs Asset Management	New York	NY	572,574
Gramercy Advisors, LLC	Greenwich	CT	1,083,774
Greylock Capital Management, LLC	New York	NY	2,134,828
Legg Mason Real Estate Advisors	Philadelphia	PA	46,712
MDL Capital Management	Pittsburgh	PA	145,780
Morgan Stanley Dean Witter (Domestic)	West Conshohocken	PA	1,389,520
NISA Custom Interest Fixed Income	St. Louis	MO	593,679
Oaktree Capital Management, LLC - Mezzanine Fund	Los Angeles	CA	762,395
Pacific Investment Management Co. (PIMCO)	Newport Beach	CA	1,152,576
Standish Mellon (Mellon Bond Associates)	Philadelphia	PA	61,177
Stone Harbor EMD	New York	NY	1,659,488
Stone Harbor High Yield	New York	NY	2,628,335
Taplin, Canida & Habacht	Miami	FL	263,793
TCW III	Los Angeles	CA	3,322
W. R. Huff Asset Management	Morristown	NJ	2,166,074

### Real Estate

Apollo Real Estate Investment Fund III	New York	NY	225,303
Berwind Property Group Fund IV	Philadelphia	PA	50,289
Berwind Property Group Fund V	Philadelphia	PA	151,712
Berwind Property Group Fund VI	Philadelphia	PA	228,536

## Fees to Managers *(Real Estate, continued)*

Berwind Property Group Fund VII	Philadelphia	PA	303,383
Blackstone Real Estate Partners III	New York	NY	88,561
Blackstone Real Estate Partners IV TE. 2 L.P.	New York	NY	53,421
Blackstone V	New York	NY	750,000
Cliffwood Partners, LLC	Los Angeles	CA	2,373,158
CRA Real Estate Securities	Radnor	PA	1,570,589
Fillmore Capital Partners	San Francisco	CA	474,908
Forest Investment Associates	Atlanta	GA	1,041,247
Goldman Sachs & Co. (Whitehall V and VI)	New York	NY	30,600
Goldman Sachs & Co. (Whitehall VII and VIII)	New York	NY	47,663
Goldman Sachs & Co. (Whitehall V-S and VI-S)	New York	NY	7,166
Heitman Capital Management, Inc.	Chicago	IL	204,416
LaSalle Advisors Limited	Baltimore	MD	797,484
Legg Mason Real Estate Advisors, Inc.	Radnor	PA	4,594,262
Lowe Enterprises Investment Management, Inc.	Los Angeles	CA	1,530,808
Lubert Adler Management II	Philadelphia	PA	48,888
Lubert Adler Management III	Philadelphia	PA	62,557
Lubert Adler Management IV	Philadelphia	PA	364,682
Oaktree Capital Management - Opportunity Fund II	New York	NY	25,962
Oaktree Capital Management - Opportunity Fund III	Los Angeles	CA	297,871
Prudential Latin America Retail Fund	Parsippany	NJ	62,500
Prudential Senior Housing Partners I	Atlanta	GA	20,253
Prudential Senior Housing Partners II	Atlanta	GA	93,621
Prudential Senior Housing Partners III	Atlanta	GA	435,069
Rockpoint Real Estate Fund I	Dallas	TX	256,612
Rockpoint Real Estate Fund II	Dallas	TX	525,000
Sentinel Corporation	New York	NY	829,911
Starwood Opportunity - Fund IV	Greenwich	CT	47,902
Starwood Opportunity - Fund VI	Greenwich	CT	377,395
Starwood Opportunity - Fund VII	Greenwich	CT	334,876
Trust Company of the West - Fund VI	Los Angeles	CA	476,190
UBS Realty Investors	Hartford	CT	577,286
UBS Brinson - RESA	Hartford	CT	871,833
UBS Brinson- MFT	Hartford	CT	1,032,079
Urdang Investment Management	Plymouth Meeting	PA	285,191
Westbrook Real Estate L.P. - Fund II	New York	NY	64,656
Westbrook Real Estate L.P. - Fund III	New York	NY	138,932
Westbrook Real Estate L.P. - Fund IV	New York	NY	175,426
Westbrook Real Estate L.P. - Fund V	New York	NY	347,747
Westbrook Real Estate L.P. - Fund VI	New York	NY	672,604
<b>Venture Capital</b>			
Abingworth Bioventures IV L.P.	London	UK	500,000
Accel Europe	Princeton	NY	250,000
Adams Capital Management - Fund III	Sewickley	PA	165,000
Advanced Technology Ventures- Fund VI	Waltham	MA	202,500
Advanced Technology Ventures- Fund VII	Waltham	MA	404,047

## Fees to Managers *(Venture Capital, continued)*

Alloy Ventures 2000	Palo Alto	CA	733,854
Alloy Ventures 2002	Palo Alto	CA	612,824
Alloy Ventures 2005	Palo Alto	CA	312,500
APA Excelsior - Fund VI	King of Prussia	PA	92,836
Apex - Fund IV	Chicago	IL	29,288
Apex - Fund V	Chicago	IL	337,500
Atlas Venture - Fund IV	Boston	MA	246,822
Atlas Ventures - Fund V	Boston	MA	748,515
Atlas Ventures - Fund VI	Boston	MA	653,647
Austin Ventures - Fund VIII	Austin	TX	491,052
Austin Ventures IX	Austin	TX	300,000
Bachow Investment Partners - Fund III	Bala Cynwyd	PA	1,980
Birchmere Ventures Fund III	Pittsburgh	PA	243,432
Care Capital III	Princeton	NJ	575,623
Charles River - Fund XI	Waltham	MA	158,807
Clearstone Venture Partners III-A	Santa Monica	CA	151,758
Cross Atlantic Technology Fund	Radnor	PA	167,885
Cross Atlantic Technology - Fund II	Radnor	PA	577,355
Draper Fisher Jurvetson - Fund VI	Redwood City	CA	200,000
Draper Fisher Jurvetson - Fund VII	Redwood City	CA	500,000
Draper Triangle Capital Fund	Pittsburgh	PA	350,000
Draper Triangle Capital Fund II	Pittsburgh	PA	240,000
Edison Ventures - Fund III	Lawrenceville	NJ	17,753
Fairview Capital - Fund I	Farmingham	CT	99,004
Fairview Capital - Fund II	Farmingham	CT	99,004
Frazier Healthcare - Fund III	Seattle	WA	290,136
Frazier Healthcare - Fund IV	Seattle	WA	569,789
Frazier Healthcare - Fund V	Seattle	WA	517,830
Grotech Partners - Fund V	Timonium	MD	448,888
Halpern Denny & Co - Fund II	Boston	MA	252,432
Halpern Denny & Co - Fund III	Boston	MA	422,718
Harbourvest Partners, LLC - Fund VI	Boston	MA	2,000,000
Harbourvest Partners, LLC - Fund VII	Boston	MA	750,000
Harbourvest VIII	Boston	MA	121,328
Healthcare Ventures - Fund V	Princeton	NJ	287,363
Healthcare Ventures - Fund VI	Princeton	NJ	584,060
Healthcare Ventures - Fund VII	Princeton	NJ	696,021
Healthcare Ventures - Fund VIII	Princeton	NJ	600,000
Highland Capital Partners - Fund VI	Boston	MA	625,001
I. P. - Fund III	Bellevue	WA	95,788
Interwest Partners - Fund VIII	Menlo Park	CA	621,728
Interwest Partners - Fund IX	Menlo Park	CA	500,000
J. H. Whitney & Co. Equity Partners - Fund III	Stamford	CT	298,285
J. H. Whitney & Co. Equity Partners - Fund IV	Stamford	CT	200,000
J. H. Whitney & Co. Equity Partners - Fund V	Stamford	CT	239,977
JMI Equity Fund V	Wilmington	DE	451,508
JP Morgan Investment Management - Fund I	New York	NY	1,085,656



## Fees to Managers *(Venture Capital, continued)*

JP Morgan Investment Management - Fund II	New York	NY	1,100,000
JP Morgan Investments III	New York	NY	1,375,000
Keystone Ventures - Fund V	Philadelphia	PA	29,743
Kline Hawkes Pacific	Los Angeles	CA	297,470
Knightbridge Venture Capital Fund VI	Bartlesville	OK	140,000
Lightspeed Venture Partners VII	Menlo Park	CA	450,633
Meritech Capital Partners III	Palo Alto	CA	590,625
Meritech Cap Partners - Fund II	Menlo Park	CA	338,640
Mid-Atlantic Venture - Fund III	Bethlehem	PA	191,862
Mid-Atlantic Venture - Fund IV	Bethlehem	PA	750,000
Morgenthaler VII	Cleveland	OH	667,072
Morganthaler VIII	Cleveland	OH	375,955
New Enterprise Associates - Fund VI	Baltimore	MD	605
New Enterprise Associates - Fund VII	Baltimore	MD	181,207
New Enterprise Associates - Fund IX	Baltimore	MD	161,074
New Enterprise Associates - Fund X	Baltimore	MD	278,570
New Enterprise Associates - Fund XI	Baltimore	MD	113,408
New Enterprise Associates - Fund XII	Baltimore	MD	300,696
Nova Vita	Radnor	PA	88,518
Oak Investment Partners XI	Westport	CT	583,075
Oak Investment Partners XII	Westport	CT	286,028
PA Early Stage Fund III	Wayne	PA	200,000
Patricof & Co. Ventures Inc. - P/A Fund III	King of Prussia	PA	553,129
Pitango Venture Capital Fund IV	Herzbya	Israel	450,000
Polaris Venture Partners - Fund I	Seattle	WA	45,791
Polaris Venture Partners - Fund III	Seattle	WA	1,118,566
Polaris Venture Partners - Fund IV	Seattle	WA	1,246,766
Polaris Venture Partners - Fund V	Seattle	WA	239,198
Quaker BioVentures, L.P.	Greenville	DE	489,552
Sprout Group - Fund VII	New York	NY	31,493
Summit Accelerator	Boston	MA	103,901
Summit Partners - Fund IV	Boston	MA	23,947
Summit Partners - Fund V	Boston	MA	270,017
T Rowe Price	Baltimore	MD	477,676
TA Associates - Advent VIII	Boston	MA	326,224
TA Associates - Advent IX	Boston	MA	1,026,651
Technology Leaders - TL Ventures III	Wayne	PA	31,963
Technology Leaders - TL Ventures IV	Wayne	PA	225,687
Technology Leaders - TL Ventures V	Wayne	PA	343,101
Three Arch Partners	Wayne	PA	500,000
Three Arch Partners IV	Wayne	PA	500,000
U.S. Venture Fund VII	Menlo Park	CA	34,109
U.S. Venture Fund VIII	Menlo Park	CA	462,820
Weston Presidio Capital - Fund III	San Francisco	CA	175,000
Weston Presidio Capital - Fund IV	San Francisco	CA	656,250
Weston Presidio Capital - Fund V	San Francisco	CA	1,000,000
Worldview Technology Partners	Palo Alto	CA	453,251



# Fees to Managers *(Private Equity, continued)*

## Private Equity Investments

ABRY Mezzanine Partners, Inc.	Boston	MA	227,868
ABRY Broadcast Partners III	Boston	MA	122,274
ABRY Broadcast Partners IV	Boston	MA	68,372
ABRY Broadcast Partners V	Boston	MA	885,631
ABRY Senior Equity II	Boston	MA	339,365
ABS Capital Partners III, L.P.	Baltimore	MD	376,840
ABS Capital Partners IV, L.P.	Baltimore	MD	398,135
ABS Capital Partners V, L.P.	Baltimore	MD	375,166
AG Capital Recovery Partners II, L.P.	New York	NY	14,683
AG Capital Recovery Partners III, L.P.	New York	NY	582
AG Capital Recovery Partners IV, L.P.	New York	NY	288,535
AG Capital Recovery Partners V, L.P.	New York	NY	171,008
Alpha Private Equity Fund 4	Paris	FR	947,198
Alpha Private Equity Fund 5	Paris	FR	649,795
APAX Partners & Co. Germany - Fund II	Munich	GR	89,886
APAX Partners & Co. UK Ventures - Fund VI	London	UK	42,549
APAX Partners & Co. UK Europe - Fund IV	London	UK	477,390
APAX Partners & Co. UK Europe - Fund V	Munich	GR	184,638
APAX Partners & Co. UK Europe - Fund VI	London	UK	1,643,038
Apollo Management, L.P. - Fund V	New York	NY	185,848
Apollo Management, L.P. - Fund VI	New York	NY	501,522
Asia Pacific - Fund III	San Francisco	CA	197,228
Audax Group	Boston	MA	375,675
Audax Private Equity Fund II	Boston	MA	806,106
Avenue Special Situation Fund III	Boston	MA	750,000
Avenue Special Situation Fund IV	New York	NY	1,504,812
Bain Capital Inc. - Fund VII	Boston	MA	421,950
Bain Capital Inc. - Fund VIII-E	Boston	MA	316,353
Bain Capital Fund IX	Boston	MA	1,129,083
BC European Capital - Fund VII	New York	NY	55,091
BC European Capital - Fund VII Top Up	New York	NY	6,166
BC European Capital VIII	New York	NY	1,091,044
Berkshire Fund VI	Boston	MA	68,955
Berkshire Fund VII	Boston	MA	253,913
Blackstone Communication Partners	New York	NY	253,762
Blackstone Group - Fund III	New York	NY	118,973
Blackstone Group - Fund V	New York	NY	1,245,725
Brait IV	Grand Cayman	Cayman Island	511,978
Brynwood Partners V	Greenwich	CT	231,324
Centerbridge Capital Partners	New York	NY	538,361
Cerberus Capital Management, L.P.	New York	NY	148,548
Cerberus Capital Management, L.P. - Series II	New York	NY	124,868
Cerberus Capital Management, L.P. - Series III	New York	NY	687,500
Charterhouse Equity Partners - Fund II	New York	NY	10,881
Charterhouse Equity Partners - Fund VII	New York	NY	321,936

## Fees to Managers *(Private Equity, continued)*

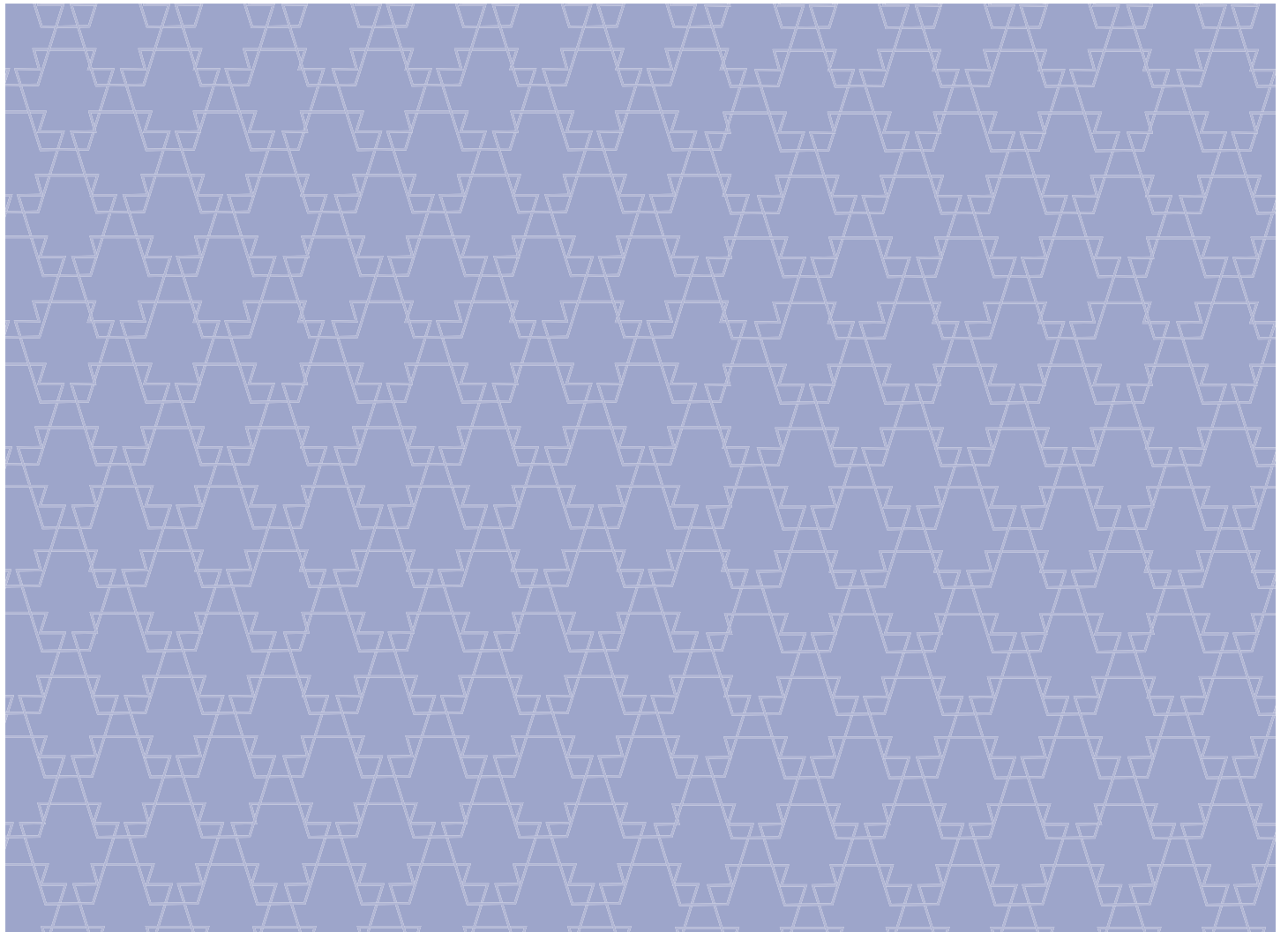
Charterhouse Equity Partners - Fund VIII	New York	NY	810,577
Chequers Capital XV	Paris	FR	453,078
Chrysalis Capital Partners II	Philadelphia	PA	700,000
Clayton, Dubilier & Rice V	New York	NY	60,043
Code, Hennessy & Simmons L.P. Fund III	Chicago	IL	113,215
Code, Hennessy & Simmons L.P. Fund IV	Chicago	IL	458,346
Code, Hennessy & Simmons L.P. Fund V	Chicago	IL	129,125
DLJ Merchant Banking - Fund II	New York	NY	231,439
Electra European Fund II	London	UK	748,788
Elevation Partners	Menlo Park	CA	797,207
Energy Spectrum Partners Fund IV	Dallas	TX	900,000
Eureka II	Yardley	PA	389,496
Excelsior Capital Asia Partners	Honk Kong		508,238
First Reserve Fund X	Greenwich	CT	387,807
Francisco Partners	San Francisco	CA	237,608
Francisco Partners II	San Francisco	CA	83,436
Frontenac Company - Fund VII	Chicago	IL	160,000
Golder, Thomas, Cressey & Rauner- Fund V	Chicago	IL	117,322
Golder, Thomas, Cressey & Rauner- Fund VII	Chicago	IL	697,141
Great Hill Partners	Boston	MA	458,413
Great Hill Partners - Fund II	Boston	MA	609,751
Great Hill Partners - Fund III	Boston	MA	305,317
Gryphon Partners - Fund III	San Francisco	CA	340,915
HarbourVest International Private Equity Partners - Fund II	Boston	MA	168,581
HarbourVest International Private Equity Partners - Fund III	Boston	MA	325,912
HarbourVest International Private Equity Partners - Fund IV	Boston	MA	400,680
HarbourVest International Private Equity Partners - Fund V	Boston	MA	262,275
Hellman & Friedman - Fund III	San Francisco	CA	4,839
Hellman & Friedman - Fund V	San Francisco	CA	317,233
JH Whitney VI	New Canaan	CT	1,189,807
Invemed Catalyst Fund	New York	NY	100,086
JP Morgan US Corporate Fin. Inst. Inv. II	New York	NY	450,000
JW Childs Equity Partners III	Boston	MA	781,072
Kelso & Company - Fund VII	New York	NY	406,014
Landmark Partners Inc. - Fund IV	New York	NY	11,373
Landmark Partners Inc. - Fund V	New York	NY	15,401
Leeds Weld Equity Partners IV, L.P.	New York	NY	345,091
Lexington Capital Partners - Fund II	New York	NY	134,609
Lexington Capital Partners - Fund III	New York	NY	132,741
Lexington Capital Partners - Fund V	New York	NY	816,850
Lexington Capital Partners - Fund VI	New York	NY	605,932
Lime Rock Partners III	Westport	CT	282,942
Lime Rock Resources	Westport	CT	521,766
LLR Equity Partners	Philadelphia	PA	268,409
LLR Equity Partners II	Philadelphia	PA	499,398
Madison Dearborn Capital Partners - Fund II	Chicago	IL	141,362
Madison Dearborn Capital Partners - Fund IV	Chicago	IL	154,711

## Fees to Managers *(Private Equity, continued)*

Madison Dearborn Capital Partners - Fund V	Chicago	IL	562,270
MatlinPatterson Global Opportunities Partners L.P.	New York	NY	39,041
MatlinPatterson Global Opportunities Partners II L.P.	New York	NY	484,067
Media/Communications Partners - Fund III	Boston	MA	178,679
Media/Communications Partners - Fund IV	Boston	MA	138,945
Media/Communications Partners - Fund V	Boston	MA	524,525
Meridian Venture Partners II	Radnor	PA	527,599
Newbridge Asia III	San Francisco	CA	353,862
Newbridge Asia IV	San Francisco	CA	624,346
New York Life Cap Partners III	New York	NY	612,772
Nordic Capital V, L.P.	Channel Islands		484,955
Nordic Capital VI, L.P.	Channel Islands		1,006,740
Oakhill Capital Management Inc.	Menlo Park	CA	370,504
Oaktree Capital Management, LLC - Opportunities Fund I	Los Angeles	CA	812
Oaktree Capital Management, LLC - Opportunities Fund II	Los Angeles	CA	6,099
Oaktree Capital Management, LLC - Opportunities Fund III	Los Angeles	CA	31,480
Oaktree Capital Management, LLC - Opportunities Fund IV	Los Angeles	CA	64,739
Oaktree Capital Management, LLC - Opportunities Fund V	Los Angeles	CA	500,000
Oaktree Capital Management, LLC - Opportunities Fund VI	Los Angeles	CA	713,315
Oaktree Capital Management, LLC - Principal Opp. Fund	Los Angeles	CA	10,256
Oaktree Capital Management, LLC - Principal Opp. Fund II	Los Angeles	CA	116,124
OCM/GFI Power Opportunities II	Los Angeles	CA	620,273
Palamon Capital Partners, L.P.	London	UK	344,670
Palamon European Equity Fund II	London	UK	635,941
Parthenon Investments II	Boston	MA	341,224
Permira IV	Boston	MA	583,543
Permira European - Fund I	London	UK	212,216
Permira European - Fund II	London	UK	234,675
Permira European - Fund III	London	UK	921,911
Permira UK - Fund IV	London	UK	42,025
Providence Equity Partners IV	Providence	RI	97,623
RRZ Capital Group Inc. - Private Equity Fund	Pittsburgh	PA	189,300
SCP Private Equity Partners - Fund II	Wayne	PA	519,987
Shoreview Capital Partners	Minneapolis	MN	462,484
Sigular Guff BRIC Opp. Fund	New York	NY	96,704
Sterling Capital Partners	Northbrook	IL	165
Sterling Capital Partners II	Northbrook	IL	484,239
Summit Partners - Venture VI	Boston	MA	1,117,556
Summit Partners - Venture VII	Boston	MA	131,933
TA Associates X	Boston	MA	138,795
Trust Company of the West - Special Credits V	Los Angeles	CA	35,153
Thomas Lee Company - Equity IV	New York	NY	106,580
Thomas Lee Company - Equity VI	New York	NY	315,817
TPG Partners L.P. Fund II	Fort Worth	TX	129,860
TPG Partners L.P. Fund IV	Fort Worth	TX	88,818
TPG Partners L.P. Fund V	Fort Worth	TX	710,728
UMS Partners I	Philadelphia	PA	100,000

## Fees to Managers *(Private Equity, continued)*

Vestar Capital Partners - Fund III	New York	NY	199,366
Vestar Capital Partners - Fund IV	New York	NY	551,094
Vestar Capital Partners - Fund V	New York	NY	317,182
<b>Total</b>			<b><u>\$286,752,403</u></b>

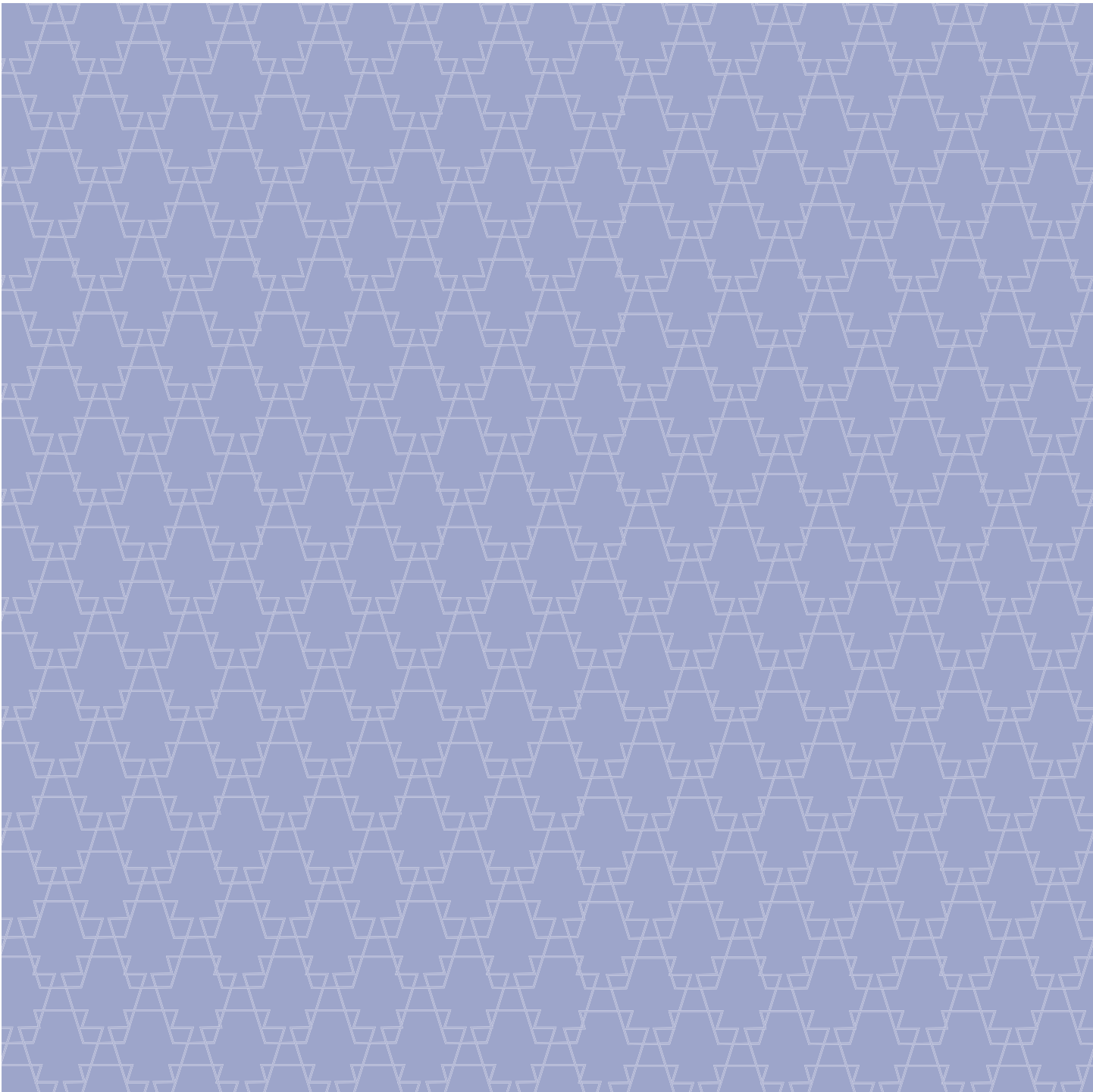


## Directed Commissions



# Directed Commissions

	<b>FY 2006-07 Budget</b>	<b>FY 2007-08 Budget</b>
Beginning Balance	\$3,027,156	\$2,777,156
Directed Commissions/Revenue	750,000	600,000
<b>Total Available</b>	<b>\$3,777,156</b>	<b>\$3,377,156</b>
<i>Investment Consultants Expenses</i>	\$1,000,000	\$1,000,000
<b>Ending Balance</b>	<b>\$2,777,156</b>	<b>\$2,377,156</b>



## Member Services and Demographics

# Member Services

The Bureau of Member Services provides a variety of services to SERS active members and annuitants. Following are lists of services provided through the seven Regional Retirement Counseling Centers.

## Services to Active Members

- Calculate retirement and vesting estimates upon request
- Make counseling available to member beneficiaries and survivors
- Conduct Question & Answer, Pre-Retirement and Vestee Seminars
- Serve as a resource speaker to groups
- Conduct research, provide estimates and counsel new members on multiple-service and creditable state and non-state service purchases
- Provide information on eligibility for state health benefits

## Services to Retired Members

- Provide direct-deposit forms, federal income tax withholding forms, beneficiary forms and change-of-address forms
- Process change of dependent information for Retired Employees Health Program coverage
- Serve as a resource speaker for groups
- Receive and process notification of annuitant death and serve as contact for beneficiaries and survivors
- Receive and process notification of the death of or divorce from a designated survivor
- Provide counseling on change of monthly annuity, when applicable

## Regional Retirement Counseling Centers

**Region 1 Seneca Office** Serving Clarion, Crawford, Elk, Erie Forest, Jefferson, McKean, Venango and Warren counties.

**Region 2 Pittsburgh Office** Serving Allegheny, Armstrong, Beaver, Butler, Cambria, Fayette, Greene, Indiana, Lawrence, Mercer, Somerset, Washington, and Westmoreland counties.

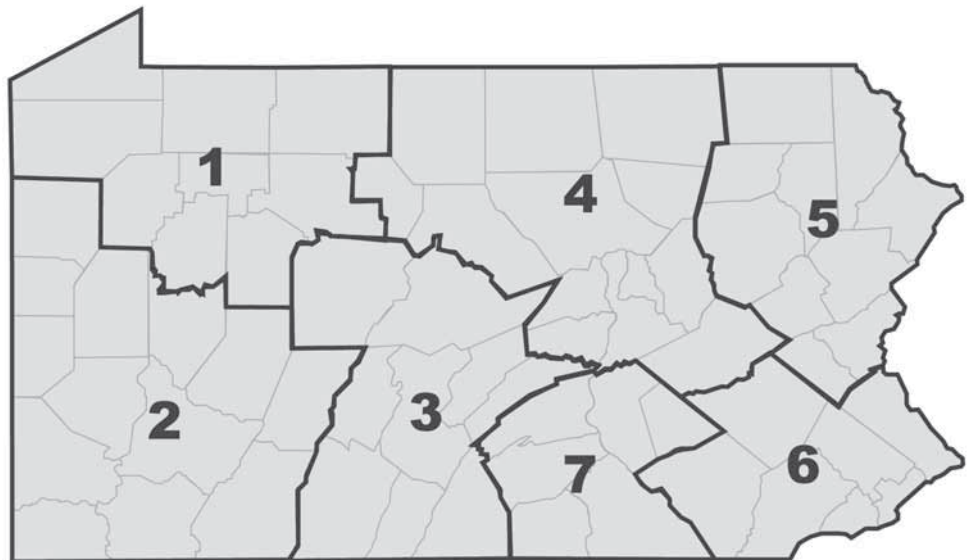
**Region 3 State College Office** Serving Bedford, Blair, Centre, Clearfield, Franklin, Fulton, Huntingdon, Juniata, Mifflin counties, and active members who are employees of Shippensburg University of Pennsylvania in Cumberland County.

**Region 4 Montoursville Office** Serving Bradford, Cameron, Clinton, Columbia, Lycoming, Montour, Northumberland, Potter, Schuylkill, Snyder, Sullivan, Tioga and Union counties.

**Region 5 Hazleton Office** Serving Carbon, Lackawanna, Lehigh, Luzerne, Monroe, Northampton, Pike, Susquehanna, Wayne and Wyoming counties.

**Region 6 Bensalem Office** Serving Berks, Bucks, Chester, Delaware, Lancaster and Montgomery counties and Philadelphia.

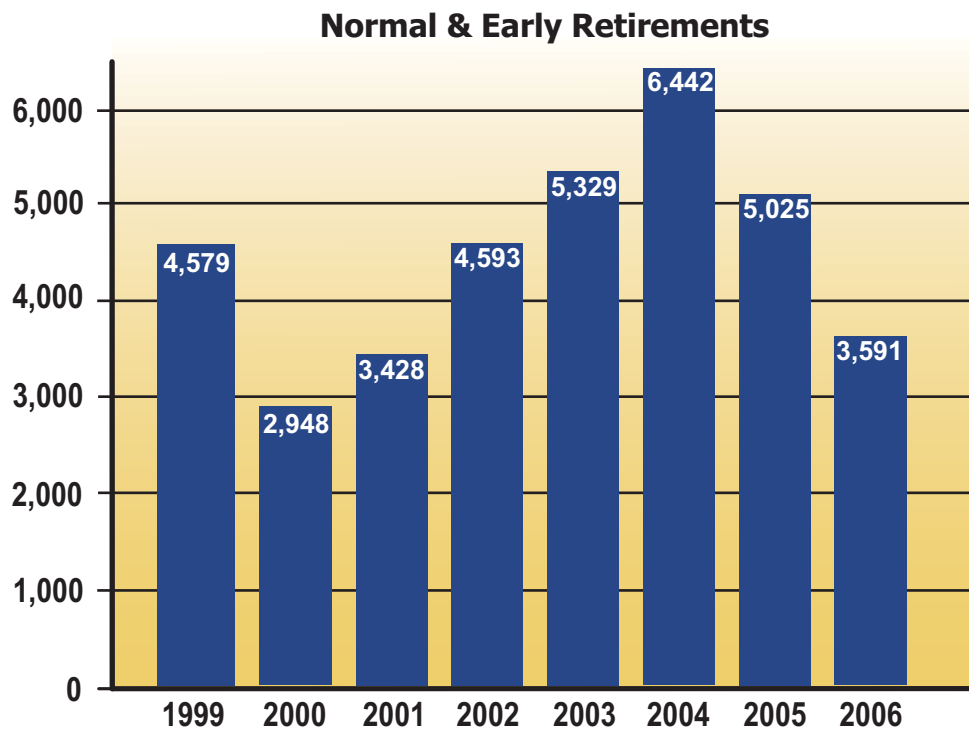
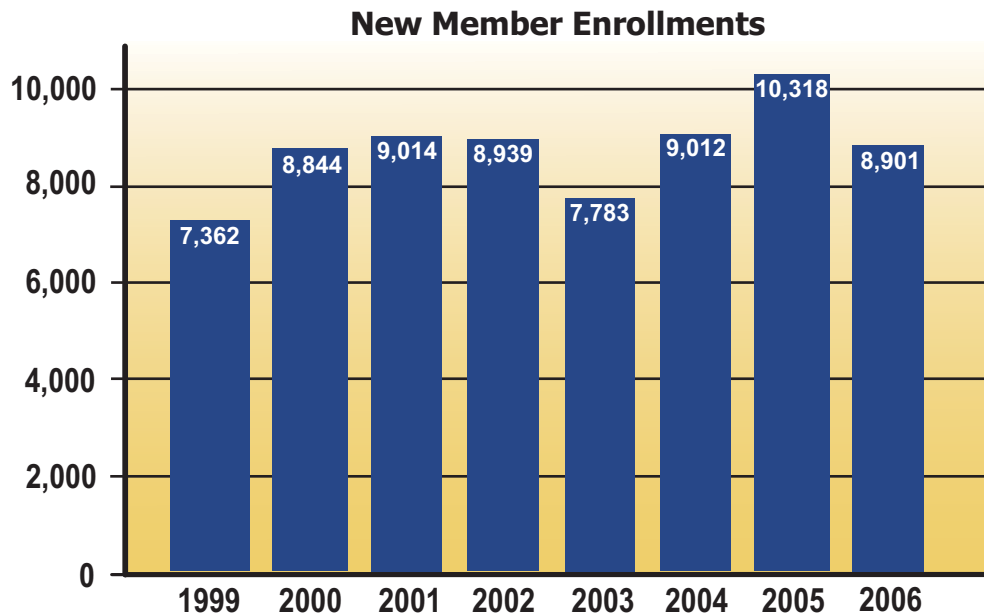
**Region 7 Harrisburg Office** Serving Adams, Cumberland (except active members who are employees of Shippensburg University of Pennsylvania), Dauphin, Lebanon, Perry and York counties.





# Benefit Processing

The following charts illustrate the work of the bureau of Member Services and Benefit Administration in member counseling and processing of benefit payments to members and their beneficiaries and survivors. Included are the numbers of new member enrollments and normal and early retirements processed in 1999 through 2006.



# SERS Member Demographics

<b>Year Ending December 31</b>	<b>Total Members</b>	<b>Active Employees</b>	<b>Annuityants &amp; Beneficiaries</b>
2006	213,032	110,972	102,060
2005	211,160	109,981	101,179
2004	207,132	108,405	98,727
2003	203,430	109,018	94,412
2002	202,287	111,059	91,228
2001	198,933	109,716	89,217
2000	197,861	109,469	88,392
1999	196,078	108,035	88,043
1998	194,727	108,893	85,834
1997	194,141	108,684	85,457
1996	194,008	110,922	83,086

Since 1996 Annuityants and Beneficiaries increased by 22.8% while the number of Active members remained relatively steady.

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## Active Employee Age and Service (as of December 31, 2006)

Average Age:	46.3
Average Years of Service:	13.2

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## Profile of Annuityants, Beneficiaries and Survivor Annuityants as of December 31

	Average Age				Average Annual Pension			
	2003	2004	2005	2006	2003	2004	2005	2006
<b>Superannuation Annuityants</b>	73.9	73.5	73.3	73.4	\$17,192	\$18,414	\$19,372	\$20,085
<b>Early Retirees</b>	60.4	60.6	60.9	61.3	12,008	12,965	13,490	13,638
<b>Disabled Annuityants</b>	59.9	60.0	60.1	60.3	11,466	11,989	12,333	12,654
<b>Beneficiary/Survivors</b>	75.3	75.1	75.0	76.0	7,072	7,549	7,981	8,308

Since 2003 the average superannuation pension is up 16.8%.

# Legislation



# Legislation

## Legislation Enacted During 2006

Two bills amending the Retirement Code (Title 71) became law during 2006.

### HB 126

HB 126 clarified SERS' right to protect the confidentiality of certain sensitive investment information, disclosure of which could harm the value of the investment. Governor Rendell signed HB 126 on Oct. 27, 2006 and it became law as Act 120 of 2006.

### SB 1285

SB 1285 contained two main provisions:

- An existing provision, allowing SERS members who become full-time elected officers of Act 195 bargaining units to have their union service credited as state service, was expanded to apply to bargaining units under Act 111 (police/fire) as well as Act 195, and to cover appointed union officials as well as elected officers.
- Additionally, the bill was amended to make retroactive the eligibility of Philadelphia Bail Commissioners for Class E-2 service credit. Those individuals had been eligible for E-2 credit prospectively from 2003. Now, their prior bail commissioner service also is eligible.

Governor Rendell signed SB 1285 on Nov. 29, 2006 and it became law as Act 188 of 2006.



## Funding Process and Actuarial Status



# Funding Process & Actuarial Status

February 16, 2007

SERS administers both a defined benefit plan (the Retirement Fund) and a defined contribution plan (the Deferred Compensation plan). This report focuses on the three sources of funding for the SERS defined benefit plan: employee contributions, which are fixed, and employer contributions and investment earnings, both of which are variable. Also included here is an explanation of supplemental annuity ("Cost Of Living Adjustment" or "COLA") funding. See illustration Sources of SERS' Funding on page 31.

## What is a Defined Benefit Pension Plan?

A *defined benefit* pension plan provides benefits that are determined by a fixed benefit formula that takes into account the employee's length of service, age and compensation, and a legislatively determined accrual rate. Actuarial calculations are used to establish the amount of contributions required to provide those benefits. The law that created SERS, the State Employees' Retirement Code (Retirement Code), provides that the Commonwealth of Pennsylvania must guarantee payment of SERS benefits.

In contrast, the Commonwealth's Deferred Compensation plan (Internal Revenue Code Section 457 plan) is a *defined contribution* plan, which provides supplemental benefits based on the member's account balance at retirement or time of distribution. Participation in the Deferred Compensation plan is voluntary, and employers do not contribute to it. While this report primarily discusses the funding of SERS' defined benefit plan, you will find additional information on the Deferred Compensation plan in Tab 12.

## Actuarial Process

The ultimate cost of the Retirement Fund is determined by the total benefits to be paid to retired employees throughout their lives and to beneficiaries of deceased members. This cost cannot be precisely determined prospectively because the commencement and duration of benefits for active employees and the duration of future benefit payments for retirees are uncertain. Therefore, pension cost determinations are based on actuarial assumptions and actuarial cost methods, which are used to establish total cost and assign that cost to periods of time. For example, the amortization period of actuarial gains and losses is established by statute. Actuarial assumptions, gains and losses vary over time and have a significant impact on the determination of an appropriate employer contribution rate.

To provide a basis for predicting future costs, SERS' actuary reviews economic and demographic experience over five-year periods. That experience is used to develop actuarial assumptions about future salary growth, investment returns, and demographic factors such as rates of retirement and death.

On an annual basis, the actuary conducts a valuation of the Retirement Fund. Based upon the latest member demographic data, the actuary determines the value of expected future obligations and compares it to the value of the Retirement Fund's assets. Based on this valuation, the actuary recommends employer contribution rates to the State Employees' Retirement Board (Board). The Retirement Code vests the Board with the authority to establish the employer contribution rates, and the Board uses the annual actuarial valuation to do so.

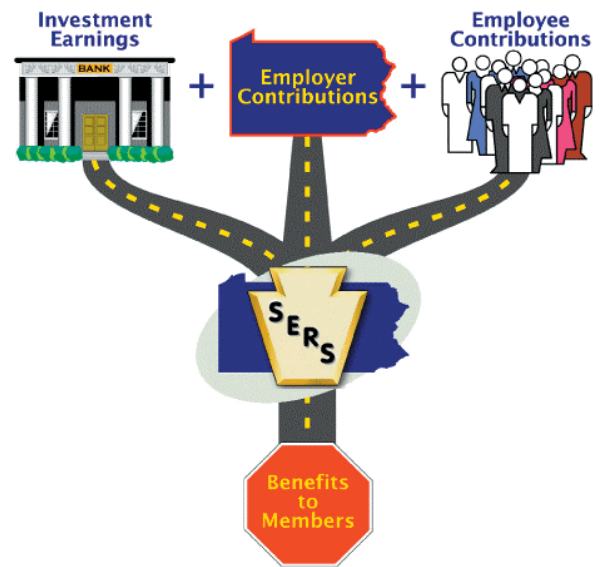
# Funding Process & Actuarial Status *(continued)*

## Interrelationship of Funding Sources

The framers of the Retirement Code designed SERS as a system that, to remain financially sound, would require regular funding each year from each of the three sources shown at right: employees, employers and investment earnings. Currently, most employees contribute 6.25% of salary, a rate set by statute. The currently assumed annual rate of return on investments is 8.5% (an assumption adopted by the SERS Board based on advice from the staff, investment consultant and actuary). The “normal” employer contribution rate - the amount employers would pay if the assumed rate of return and all other actuarial assumptions proved to be precisely correct - is 8.39% of payroll.

Obviously, however, it is beyond the power of the Board to know in advance how much investments will earn in any given year. Actual returns can vary widely; in fact, it is highly unlikely that the investment returns will precisely match the assumed return in any given year. The Retirement Code recognizes this reality and deals with it by creating a linkage between investment earnings and employer contributions. It does so by requiring the SERS Board to adjust the employer contribution rate each year based on actual investment returns and actuarial experience: When investment earnings exceed the 8.5% actuarially assumed return, the Board may be able to reduce the employer contribution rate. Conversely, when investment earnings fall short of assumptions, the Board may find it necessary to increase the employer contribution rate. Since the employee rate is fixed by statute, it does not change from year to year, regardless of investment gains or losses. The employer share, however, can and does vary widely. As discussed below, the employer share has recently been as low as zero and is currently projected to fall again to zero in the near future, before jumping to 15.1% in July 2012.

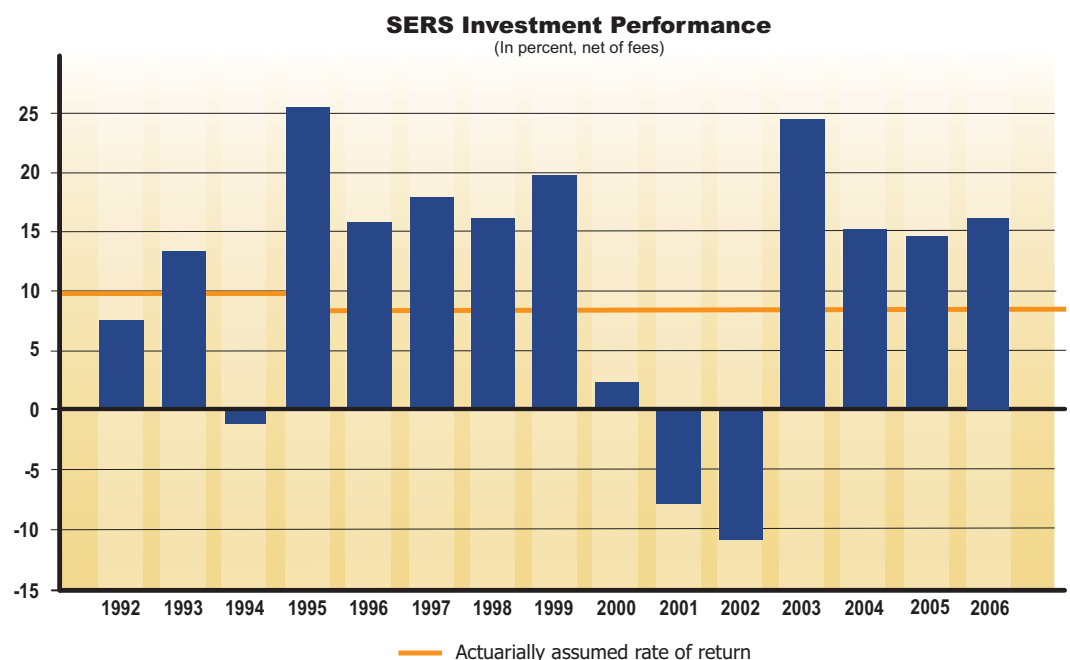
## Sources of SERS' Funding



## Funding Source 1: Investment Earnings

From 1995 through 1999, the Retirement Fund experienced investment rates of return ranging from a low of 15.9% to a high of 25.2%, and earned its best ever five-year annualized return of close to 19%. SERS also posted strong returns over the past four years, with earnings of 24.3%, 15.1%, 14.5% and 16.4% for 2003, 2004, 2005 and 2006, respectively.

**See illustration**  
***SERS Investment Performance at right.***



# Funding Process & Actuarial Status *(continued)*

Those returns significantly exceeded the actuarially assumed returns.

In order to smooth out fluctuations in the market value of assets, which could otherwise result in volatile year-to-year changes in employer contribution requirements, SERS and its actuary rely upon the actuarial value of assets (not the market value) for funding calculations. Over a 5-year period, the Actuarial Value of Assets gradually recognizes the differences between total investment return and the assumed annual rate of return. During the past 10 years, the Retirement Fund earned a compounded rate of return of 10.2%, exceeding the actuarially assumed rate of return, which has been 8.5% per year since 1995.

By allocating the investment rate of return over a 5-year period, SERS recognizes only 20% of the asset gain/loss (the difference between the actual return and the actuarial assumption at 8.5%), which occurred during the year immediately preceding the actuarial valuation date, with the remainder to be recognized (at an additional 20% per year) over the following four years. As a result, when investment earnings trends change, there is a delayed effect on employer contribution rates.

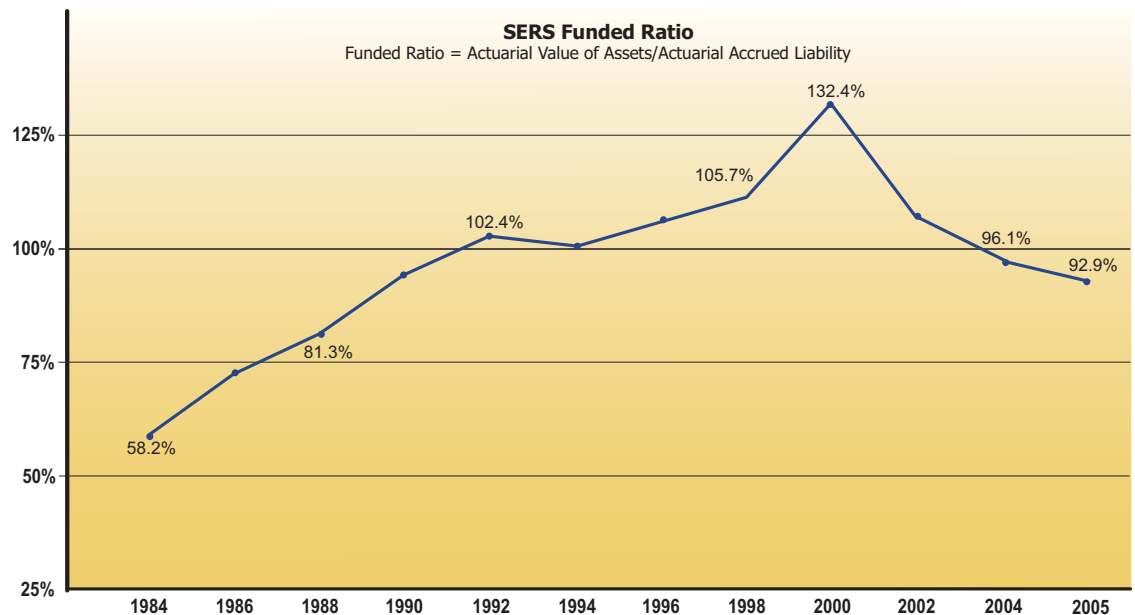
## Funded Position

The funded position of the Retirement Fund is measured by its Funded Ratio -- the Actuarial Value of Assets, divided by the Actuarial Accrued Liability. The most recent actuarial valuation of December 31, 2005, reflects that the Retirement Fund was 92.9% funded. That makes SERS one of the best-funded state pension plans in the nation. By way of comparison,

Wilshire Associates' "2006 Wilshire Report on State Retirement Systems" a compilation of 2005 data on 58 state retirement plans, found that the average funding level of those plans was just 80%.

The 92.9% funded ratio for 2005 marks a slight decline

from 2004, when SERS ended the year 96.1% funded. The system's less-than-fully-funded status is a result of less favorable investment earnings in 2000, 2001, and 2002, and Act 2001-9, which significantly increased the Retirement Fund's actuarial accrued liabilities. **See illustration *SERS Funded Ratio* above.**



- The System has used an actuarially assumed rate of return of 8.5% since 1995.
- During the past 10 years, the Retirement Fund earned a compounded rate of return of 10.2%, significantly higher than the actuarially assumed rate of return.
- As losses from the 2000-2002 period amortize into the rate calculation, employer contribution rates are expected to increase.
- SERS employs a five-year averaging method to recognize investment gains and losses.
- SERS has exceeded the actuarially assumed rate of return for 13 of the past 20 years.



# Funding Process & Actuarial Status *(continued)*

## Funding Source 2: Employer Contributions

The Board establishes the employer contribution rate annually, based upon the actuary's recommendation. The employer contribution rate is expressed as a percentage of payroll. Different service classifications of SERS members require different contribution rates.

The total Employer Contributions are made up of two parts - the Normal Cost and a contribution for the Unfunded Actuarial Liability (UAL), if any. The Normal Cost is the cost of SERS benefits to be earned in the coming year. Currently, the Normal Cost is 8.39%. The Unfunded Actuarial Liability (UAL) is the amount of the Actuarial Accrued Liability in excess of the Actuarial Value of Assets. In theory, if the UAL were zero, and all of the actuarial assumptions turned out to be correct, and there were no amendments to the Retirement Code, the Normal Cost contributions would be sufficient to fund the liabilities for all participants. However, the Normal Cost alone usually will not fund the Retirement Fund's total liabilities. The total of the liabilities that will not be funded by future Normal Cost is the Unfunded Actuarial Accrued Liability.

The UAL is amortized – that is, funded – in installments. The Retirement Code was modified in 2003 and now requires amortization payments to be in equal dollar annual installments over a period of 30 years. Act 2003-40 changed the funding period for most, but not all, of SERS' actuarial liabilities from 10 years to 30 years, effectively spreading out the payment of SERS' costs and liabilities. In essence, Act 2003-40 refinanced the pension mortgage from a 10-year term to a 30-year term. The Act also set a series of floor contribution rates. In the 2006-07 state fiscal year, employers are paying a floor rate of 4%. Act 2003-40 did not provide for any floors beyond June of this year, when the current 4% floor expires.

Prior to the enactment of Act 40, it was projected that if nothing was done, the SERS employer rate would start a steep climb in 2003-04 and would peak, in 2012, at 28.6% of payroll. Act 2003-40 changed the amortization schedule in a way that was intended to still result in regular annual employer rate increases in advance of 2012, but at lower levels, and to produce a somewhat lower 2012 peak of 24.2%. That was achieved by pushing payments into the future where, for two decades, rates would be higher than if Act 40 had not been passed. The post-2012 increase is necessitated by financing costs and the opportunity loss in not having the contribution monies available to invest and compound in the immediate period.

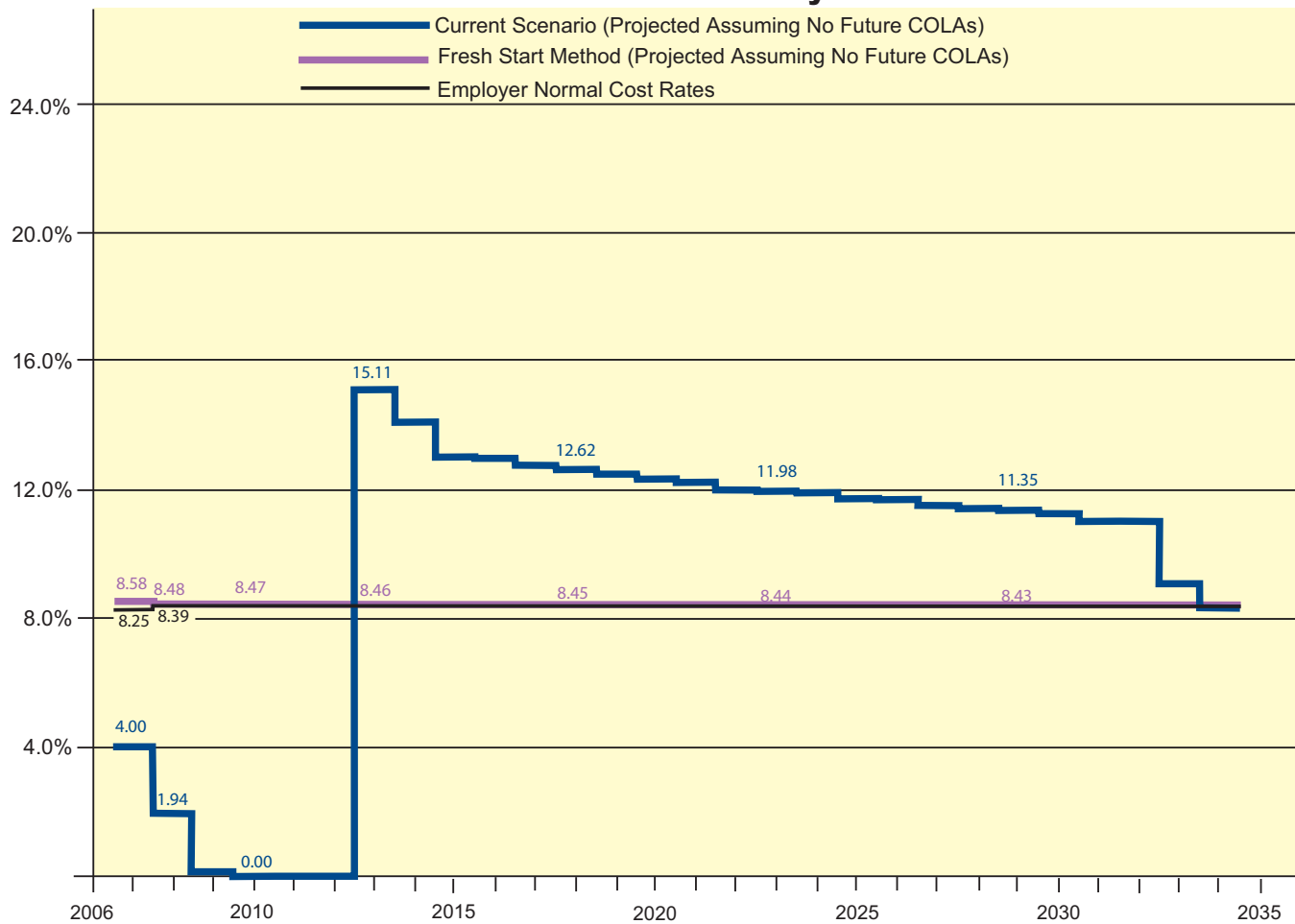
Since the enactment of Act 40, however, SERS has produced, as noted above, four years of investment returns far in excess of the assumed rate of return. The Act 40 amortization schedule, the expiration of the rate floor and four years of strong investment returns have combined to produce an unexpected result:

Rather than rising slowly between now and 2012, the SERS employer rate currently is projected to drop back down to zero for four years.

The 2012 spike is now projected at 15.1%. After that, the rate is expected to moderate but remain above 10% beyond 2030. The currently projected rates in 2012 and beyond are as high as they are because of the anticipated lack of contributions prior to 2012. If rate floors were preserved, or the Act 40 amortization schedule was revised, to prevent the rate from dropping to zero, the rates in 2012 and beyond would be lower.

In fact, SERS' actuaries have determined it would be possible to eliminate the rate spike entirely, and operate the system indefinitely at an employer rate just slightly higher than the employer normal rate of 8.39%. This could be done through an actuarial "fresh start," which would entail recognizing the current market value of assets and actuarially resetting the SERS amortization schedule to 30 years. The resulting employer rate would be less than 8.5% for the foreseeable future (assuming investment returns of 8.5% and assuming no COLAs or other costly benefit enhancements). **See illustration *Projection of SERS' Employer Contribution Rates as a Percent of Payroll*, next page.**

## Projection of SERS' Employer Contribution Rates as a Percent of Payroll



SERS-01-09-07

Other options also exist, short of a “fresh start.” Generally, any change to the funding requirements that results in employers paying more than zero in the years prior to 2012 will result in a lower rate in 2012 and thereafter. Two legislative examples are HB 126, which is pending in the current session of the legislature, and HB 2562 which passed the House but died in the Senate last session.

### Employer Contribution Provisions

- Employer contributions to SERS represent the Normal Cost to fund the Retirement Fund and payments to fund the Unfunded Actuarial Liability.
- As a result of strong investment performance, the employer contribution rate was reduced to 0.0% in the 2000 and 2001 Actuarial Reports.
- Rates are projected to once again drop to zero and remain there for four years; that four-year funding holiday contributes to the 2012 rate spike.
- Maintaining employer contributions between now and 2012 could reduce, or even eliminate, the 2012 spike.
- The currently projected 2012 rate spike is 15.1%, down from the 24.2% spike that Act 2003-40 was expected to produce.

Among the many SERS benefit costs that the actuary values each year is the cost of the Retirement Code's Option 4. Under Option 4, a retiring SERS member may elect to receive a refund of all or part of that member's accumulated deductions (employee contributions plus 4% statutory interest) and also receive a reduced annuity based on the remaining value of the member's retirement account. Election of Option 4 increases the cost to the Retirement Fund because the refund is calculated at 4% interest whereas it is assumed that, if the accumulated deductions were left in the Retirement Fund, they would earn 8.5% interest. More than 80% of retirees choose the Option 4 refund.

# Funding Process & Actuarial Status *(continued)*

## Funding Source 3: Employee Contributions

The simplest component of the funding scheme is employee contributions. Pursuant to the Retirement Code, SERS members pay a statutorily determined contribution rate. Most SERS members contribute to the Retirement Fund at the rate of 6.25% of their gross compensation. Commonwealth employees made approximately \$306 million in contributions in 2005.

- SERS active members pay a fixed percentage of compensation.
- By law, Class AA members contribute 6.25% of pay.
- Member contributions are, by statute, credited with 4% annual interest and are recorded for each individual member and reported on the member's annual Statement of Account.

## Explanation of SERS Supplemental Annuities ("Cost of Living Adjustments" or "COLAs")

The Retirement Code contains procedures, definitions, and actuarial requirements for calculating benefits. The Retirement Code does not provide for an automatic annual inflation-based COLA as Social Security does. Instead, the Legislature has from time to time voted to grant increases in benefits for retirees. While commonly referred to as "COLAs," these supplemental annuities (as they are properly known) are not dictated by any inflation-based formula. The amount and structure of each supplemental annuity is entirely within the discretion of the Legislature, and each requires new legislation. Also, because the Retirement Code does not provide for advanced funding or actuarial reserves for COLAs, COLAs historically have been funded after they have been granted. COLAs are paid from future employer contributions.

Over the past 40 years, the Pennsylvania General Assembly has legislated eight general COLAs effective in 1968, 1974, 1979, 1984, 1989, 1994, 1998, and 2002/2003. Generally, the amount of the COLA has been determined by a formula that accounts for years of service, years in retirement, and inflation since the previous COLA.

COLAs generally have been given to retirees who have reached either their normal retirement ("superannuation") age, (60 for most classes but 50 for some) or the age at which the member would have been credited with 35 eligibility points (or 30 eligibility points for "30 and Out" retirees), and all disabled retirees. COLAs are payable to early retirees once they reach superannuation age. The Pennsylvania Constitution prohibits paying COLAs to beneficiaries of deceased members or survivor annuitants.

COLAs increase the Retirement Fund's liabilities (as a result of the increases in benefits paid to members). However, the usual SERS funding mechanism does not provide a source from which to pay for the increased benefits. Therefore, when the actuary determines the cost of a COLA, the liability for the COLA is established in SERS' Supplemental Annuity Account. Under current law, the COLA liability must be amortized over 10 years, with the amortization payments being included in the employer contribution rate. Thus, the money to pay for COLAs ultimately comes from increased future employer contributions.

## Benefits to Members

- At retirement, SERS calculates the actuarial value of the annuity to be paid over the remaining life of the member and transfers the balance of the member's accumulated deductions and reserves from the State Accumulation Account into the Annuity Reserve Account to pay the lifetime benefit.
- The Annuity Reserve Account contains funds for all current retirees and beneficiaries based on the amount of the original benefit at retirement.
- No funds are in the Annuity Reserve Account to pay for future COLAs.

## Payment Methods

Members may elect to take a lump sum withdrawal of accumulated deductions (Option 4) and receive a reduced retirement annuity.

# Funding Process & Actuarial Status *(continued)*

## Funding of Supplemental Annuities

- Because the Retirement Code does not provide for automatic COLAs or the necessary funding, each new supplemental annuity must be legislated individually.
- Every supplemental annuity or COLA enacted since 1968 required an amendment to the Retirement Code and added a new liability to the Retirement Fund.



# Investment Policy, Objectives and Performance

# Investment Policy

The State Employees' Retirement Board originally adopted a formal Statement of Investment Policy in 1979. It has been revised periodically, principally to reflect and incorporate legislative changes governing investments. The latest Statement of Investment Policy was adopted in 2004. The purpose of the statement is to formalize the Board's investment objectives, policies, and procedures: to establish guidelines for the investment of Fund assets, and to define the duties and responsibilities of the various entities involved in the investment process. The major elements of the statement are:

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

# Investment Objectives

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

- Achieve a net total return equivalent to the actuarial return assumption, or preferably in excess of this rate in order to improve the funded ratio of the Fund through investment earnings.
- Achieve in Global Stocks a total return that exceeds the total return of the MSCI World Index;
- Achieve in Domestic Stocks a total return that exceeds the total return of the Russell 3000 Index;
- Achieve in International Stocks a total return that exceeds the total return of the SERS Custom International Stock Index;
- Achieve in the Fixed Income asset class a total return that exceeds the total return of the SERS Fixed Income Custom Index;
- Achieve in Inflation Protection a total return that exceeds the total return of the SERS Inflation Protection Custom Benchmark;
- Achieve in the Equity Real Estate asset class a total return that exceeds the total return of the Townsend Stylized Benchmark;
- Achieve in the Cash asset class a total return that exceeds the total return on U.S. Treasury Bills (90 days);
- Achieve in the Venture Capital asset class a total return that exceeds the Cambridge Venture Capital Benchmark;
- Achieve in the Private Equity asset class a total return that exceeds the Cambridge Private Equity Benchmark.

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

# Asset Allocation Trends

## Investment Standards

The SERS Board of Trustees' investment authority is governed by the "prudent investor" standard as set forth in Title 71, Pennsylvania Consolidated Statutes, Section 5931(a). Enactment of the "prudent investor" standard in Act 1994-29 and the 2003 asset/liability study completed by Rocaon Investment Advisors and the SERS Investment Staff are the foundation of SERS' "2007 Annual Five-Year Investment Plan." With prudent investor investment authority, SERS is able to pursue a broader array of investment opportunities that enhance the ability to achieve competitive rates of return while maintaining risk at acceptable levels. The asset/liability study demonstrated that the prudent application of this expanded authority should result in a more efficient portfolio that better serves the needs of SERS.

## Total Fund Asset Allocation Trend: 2007 through 2011

SERS will implement the "Investment Plan" over a period of five years. Thus, the Fund's asset allocation strategy will evolve over this timeframe until the long-term targets for each asset category are achieved by the end of the year 2011. The evolution of the asset allocation strategy is reflected in the table below.

2006		2007	2008	2009	2010	2011
56.3%	Stocks	55.0%	52.0%	47.0%	47.0%	47.0%
15.3%	Fixed Income	16.5%	19.0%	24.0%	24.0%	24.0%
7.9%	Real Estate	8.0%	8.0%	8.0%	8.0%	8.0%
13.2%	Alternative Investments	13.5%	14.0%	14.0%	14.0%	14.0%
6.1%	Inflation Protection	7.0%	7.0%	7.0%	7.0%	7.0%
1.2%	Cash	0.0%	0.0%	0.0%	0.0%	0.0%
100.0%		100.0%	100.0%	100.0%	100.0%	100.0%



# Estimated Investment Performance\*

## Calendar Year Basis

through December 31, 2006 (net of fees)

Asset Class	1 Year Total Return	3 Year Total Return	5 Year Total Return	10 Year Total Return
Domestic Stocks	18.8%	13.6%	9.3%	9.6%
Russell 3000 Index <sup>1/</sup>	15.7%	11.2%	7.2%	8.5%
International Stocks	26.8%	22.2%	16.7%	10.8%
SERS Custom International Stock Benchmark (26% Hedged) <sup>2/</sup>	28.2%	23.6%	17.6%	9.1%
Fixed Income	7.7%	6.7%	7.9%	7.1%
SERS Custom Fixed Income Benchmark	7.6%	5.8%	7.1%	6.4%
Cash	4.9%	3.2%	2.7%	3.9%
90 day U.S. T-bills	4.9%	3.1%	2.4%	3.8%
Real Estate <sup>3/</sup>	17.6%	20.8%	15.5%	13.8%
Townsend Stylized Benchmark	20.1%	18.5%	14.2%	13.1%
Private Equity <sup>3/</sup>	23.2%	28.6%	17.2%	16.8%
Cambridge Private Equity Index	22.6%	26.0%	15.6%	14.8%
Venture Capital <sup>3/</sup>	5.4%	3.6%	-7.1%	7.0%
Cambridge Venture Capital Index	9.5%	10.8%	-3.5%	16.7%
Inflation Protection <sup>4/</sup>	-6.3%	12.0%	17.5%	N/A
Inflation Protection Custom Index	-6.5%	10.9%	16.8%	5.6%
<b>Total Fund</b>	<b>16.4%</b>	<b>15.4%</b>	<b>11.2%</b>	<b>10.2%</b>
<b>Total Fund Benchmark</b>	<b>16.0%</b>	<b>14.7%</b>	<b>10.6%</b>	<b>9.5%</b>

\* Returns for periods longer than one year are annualized.

<sup>1/</sup>The Domestic Stocks Benchmark is the Wilshire 5000 Index through 12/31/98, and the Russell 3000 thereafter.

<sup>2/</sup>The International Stocks Composite and the Custom International Index were unhedged prior to 5/1/96.

<sup>3/</sup>Results for the Real Estate, Private Equity, Venture Capital and Indices are lagged one quarter.

<sup>4/</sup>Inflation Protection was initially funded in November, 2001.

# Investment Performance\*

## Commonwealth Fiscal Year Basis

through June 30, 2006 (net of fees)

Asset Class	1 Year Return	3 Year Return	5 Year Return	10 Year Return
Domestic Stocks	13.1%	15.2%	5.5%	9.3%
Russell 3000 Index <sup>1/</sup>	9.6%	12.6%	3.5%	8.3%
International Stocks	26.3%	25.5%	11.4%	9.5%
SERS Custom International Stock Benchmark (26% Hedged) <sup>2/</sup>	30.1%	27.3%	12.2%	7.4%
Fixed Income	2.6%	5.9%	7.1%	7.1%
SERS Custom Fixed Income Benchmark	1.9%	4.1%	6.5%	6.4%
Cash	4.1%	2.5%	2.3%	4.0%
90 day U.S. T-bills	4.0%	2.4%	2.3%	3.8%
Real Estate <sup>3/</sup>	30.9%	20.9%	14.6%	13.6%
Townsend Stylized Benchmark	23.7%	18.4%	13.4%	12.8%
Private Equity <sup>3/</sup>	32.8%	29.0%	13.3%	16.9%
Cambridge Private Equity Index	31.7%	27.5%	12.4%	15.2%
Venture Capital <sup>3/</sup>	12.0%	2.6%	-11.3%	7.4%
Cambridge Venture Capital Index	13.8%	9.7%	-9.0%	18.7%
Inflation Protection <sup>4/</sup>	17.8%	21.8%	N/A	N/A
Inflation Protection Custom Index	17.3%	20.6%	14.8%	8.2%
Total Fund	17.1%	17.1%	8.4%	10.0%
Total Fund Benchmark	16.2%	16.0%	7.7%	9.3%

\* Returns for periods longer than one year are annualized.

<sup>1/</sup>The Domestic Stock Benchmark was the Wilshire 5000 through 12/31/98, and the Russell 3000 thereafter.

<sup>2/</sup>The SERS Custom International Stock Benchmark (26% Hedged) was unhedged prior to May 1, 1996.

<sup>3/</sup>Results for the Real Estate, Private Equity, Venture Capital and Indices are lagged one quarter.

<sup>4/</sup>Inflation Protection was initially funded in November of 2001.

# Investment-Related Statistics

1980 - 2006

Year End	SERS Fund Market Value (\$ millions) <sup>1/</sup>	# of Investment Advisors	# of Portfolios	# of Consultants	Annual Total Fund Rate of Return
1980	\$2,689	3	3	3	5.3%
1981	2,817	5	6	3	0.9%
1982	3,730	6	7	4	27.8%
1983	4,396	14	17	4	13.0%
1984	4,922	22	24	4	9.4%
1985	6,157	23	26	3	23.1%
1986	7,120	30	34	3	15.2%
1987	7,367	37	42	3	3.3%
1988	8,312	41	49	3	12.8%
1989	9,785	47	59	4	17.8%
1990	9,886	53	65	4	1.0%
1991	11,940	56	68	4	22.6%
1992	12,453	66	79	4	7.4%
1993	13,701	61	80	4	13.2%
1994	13,330	78	100	4	- 1.1%
1995	16,343	81	103	4	25.2%
1996	18,492	96	126	4	15.9%
1997	21,312	112	154	4	18.0%
1998	24,123	99 <sup>2/</sup>	163	3	16.3%
1999	28,093	116	204	3	19.9%
2000	27,881	132	245	3	2.2%
2001	24,706	143	277	3	-7.9%
2002	20,880	149	289	3	-10.9%
2003	24,535	153	295	4	24.3%
2004	26,641	163	324	4	15.1%
2005	28,805	167	364	3	14.5%
2006	32,098	180	403	3	16.4%

<sup>1/</sup> Market values for Real Estate and Alternative Investments are lagged by one quarter adjusted for allocations and distributions. Market values also include non-investment receivables and payables.

<sup>2/</sup> Restated in 1998 and thereafter to eliminate double counting of managers managing assets across asset classes

# Plan & Investment Class Rankings

as of September 30, 2006

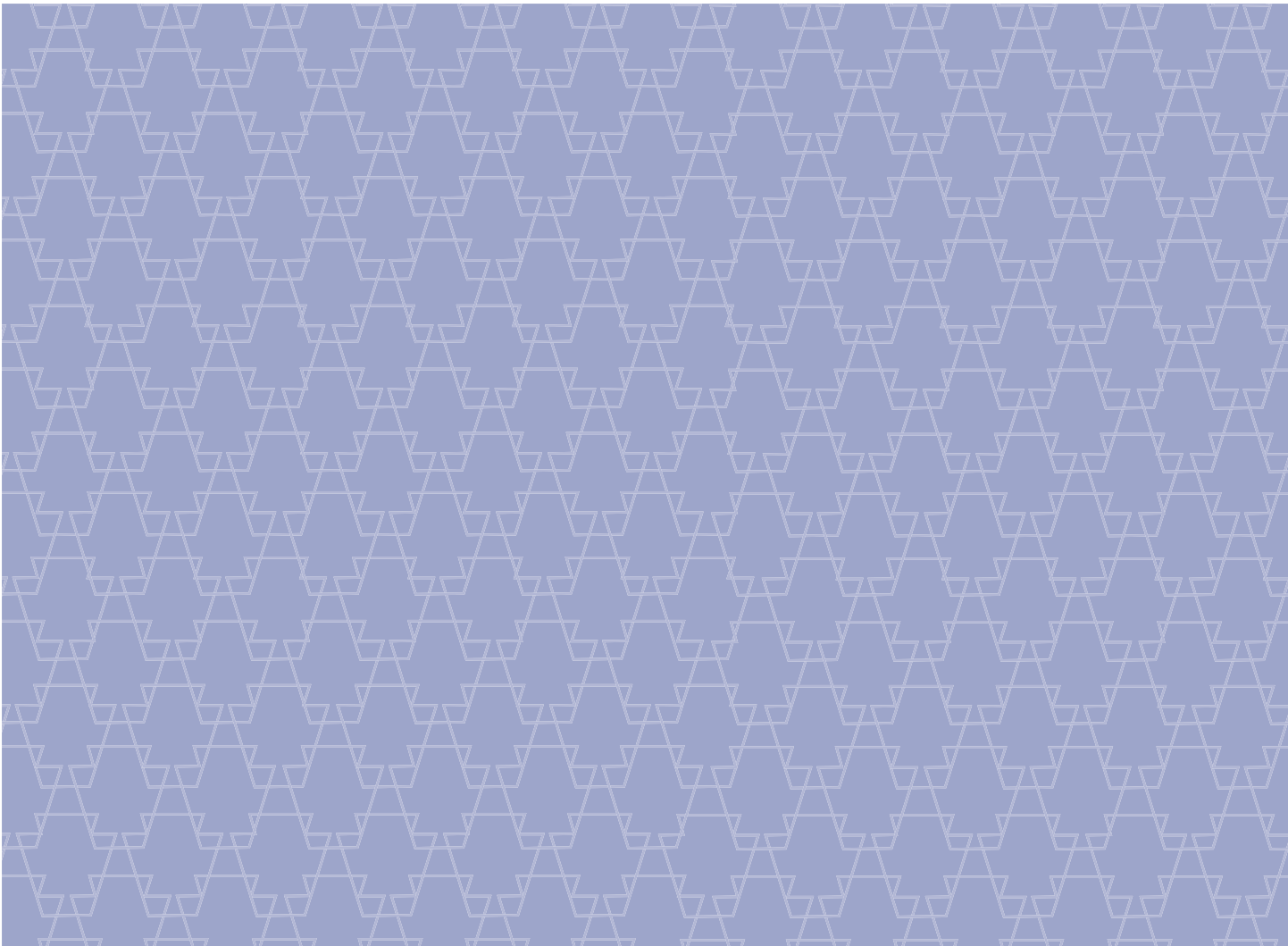
The January 22, 2007, edition of Pensions & Investments listed a ranking of U.S. pension plan sponsors according to total assets and amounts invested in various asset classes as of September 30, 2006. The survey results for the total SERS Fund (defined benefit plan plus the defined contribution plan), as well as for various asset classes are listed below.

Category	Amount (\$ mil)	Total Fund Rank	Public Fund Rank
SERS <sup>1/</sup>	\$31,978	38 <sup>th</sup>	25 <sup>th</sup>
Venture Capital <sup>2/</sup>	1,057	7 <sup>th</sup>	5 <sup>th</sup>
Private Equity <sup>3/</sup>	758	11 <sup>th</sup>	8 <sup>th</sup>
Distressed Debt <sup>3/</sup>	297	9 <sup>th</sup>	7 <sup>th</sup>
Buyouts <sup>3/</sup>	1,929	11 <sup>th</sup>	9 <sup>th</sup>
Real Estate Equity	2,298	22 <sup>nd</sup>	18 <sup>th</sup>

<sup>1/</sup> The Pensions & Investments survey ranked plan sponsors according to the combined assets of their defined benefit and defined contribution plans.

<sup>2/</sup> The Venture Capital data reflects only the market value of actual funded investments as of June 30, 2006. SERS also has outstanding unfunded commitments for the Venture Capital area that have been approved by our Board of Trustees. In total, SERS has made \$3,427.5 million in actual Venture Capital commitments through December 31, 2006.

<sup>3/</sup> The Private Equity data reflects only the market value of actual funded investments as of June 30, 2006. SERS also has outstanding unfunded commitments for the Private Equity area that have been approved by our Board of Trustees. In total, SERS has made \$7,885.7 million in actual Private Equity, Distressed Debt and Buyout commitments through December 31, 2006.



## Investment Program Summary



# Investment Program Summary

as of December 31, 2006

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

**Market Value as of December 31, 2006:** SERS' assets had an unaudited market value of approximately \$32,098.2 million.

Asset Class	SERS Asset Allocation		2006 Target Allocation	Long-Term Target Allocation
	Market Value (Unaudited)			
	\$ (mil)	%		
Global Stocks	\$1,584.7	4.9%	4.8%	5.0%
Domestic Stocks	9,929.2	30.9%	32.9%	27.5%
International Stocks	6,580.3	20.5%	18.8%	14.5%
Fixed Income	4,911.9	15.3%	16.5%	24.0%
Cash	380.6	1.2%	0.0%	0.0%
Real Estate	2,529.9	7.9%	8.0%	8.0%
Alternative Investments	4,223.4	13.2%	12.0%	14.0%
Inflation Protection	1,958.1	6.1%	7.0%	7.0%
<b>Total</b>	<b>\$32,098.2</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>

*Numbers may not add due to rounding.*

**Number of Investment Advisors:** SERS had 180 external investment advisory firms managing portfolios. There are 47 advisors in the public markets domain and 155 covered alternative investments and real estate. Fifteen of these advisors manage 36 portfolios across asset classes.

- 2 Global Stock advisors
- 12 U.S. Stock advisors
- 12 International Stock advisors
- 2 Currency Overlay advisors
- 16 Fixed Income advisors
- 1 Cash advisor
- 2 Inflation Protection advisors
- 25 Real Estate advisors
- 53 Venture Capital general partners managing limited partnerships
- 77 Private Equity general partners managing limited partnerships

In addition, Board appointments included four domestic stock advisors, one venture capital general partnership, and two real estate advisors.

**Number of Investment Portfolios:** SERS had 403 investment portfolios/accounts. Fifty-four of these accounts are public market investments, while 349 covered private markets.

- 2 Global Stock advisors
- 13 U.S. Stock portfolios
- 16 International Stock portfolios
- 2 Currency Overlay portfolios
- 18 Fixed Income portfolios
- 1 Cash portfolio
- 2 Inflation Protection portfolios
- 55 Real Estate portfolios
- 111 Venture Capital limited partnership interests
- 183 Private Equity limited partnership interests

In addition, Board appointments included four domestic stock accounts, five real estate portfolios, three private equity limited partnerships, and two venture capital limited partnerships.

# Global Stock Investments Summary

as of December 31, 2006

Global stocks is a component of the stock asset class, one of eight major asset classes which SERS uses to diversify the investments of the Fund. SERS' investment plan diversifies stock investments while maintaining a reasonable risk posture relative to the benchmarks. SERS contracts with external investment advisors to manage portfolios.

**Policy:** Stock investments are employed by the Fund primarily because their expected large return premiums versus inflation will, if realized, help preserve and enhance the real value of the Fund over long periods of time. The global stocks accounts are managed on a total return basis.

SERS' long term investment objective for the global stock component of the stock asset class is to achieve a total return, net of fees, that exceeds the total return of the MSCI World Index.

SERS' 2006 Investment Plan targets an allocation of 5% of Fund assets to global stocks.

**Market Value as of December 31, 2006:** Global stocks had a \$1,584.7 million market value, 4.9% of the total Fund's \$32,098.2 million market value.

**Number of Investment Advisors:** SERS had contracts with two external investment advisors to manage global stock portfolios.

**Number of Investment Portfolios:** SERS had two global stock portfolios managed by the two investment advisors.

**Type of Investment Portfolios:** As of December 31, 2006, SERS global stock allocation was to large cap strategies.

Global Stock Investment Advisor		Market Value* as of 12/31/06 (\$ millions)
1. Walter Scott & Partners Limited	growth	\$646.1
2. Marathon-London Global Fund	contrarian sector relative value	938.6
<b>Total Global Stocks</b>		<b>\$1,584.7</b>

*\*Includes stocks and cash which the manager had available for investment. Numbers may not add due to rounding*

# U.S. Stock Investments Summary

as of December 31, 2006

U.S. Stocks is one of eight major asset classes which SERS uses to diversify the investments of the Fund. SERS' investment plan diversifies stock investments while maintaining a reasonable risk posture relative to the benchmark. SERS contracts with external investment advisors to manage portfolios.

**Policy:** Stock investments are employed by the Fund primarily because their expected large return premiums versus inflation will, if realized, help preserve and enhance the real value of the Fund over long periods of time. The U.S. stock asset class is managed on a total return basis.

SERS' long term investment objective in the U.S. Stock asset class is to achieve a total return, net of fees, that exceeds the total return of the Russell 3000 Index.

Stock investments shall include, but not be limited to, publicly traded securities which provide SERS with an equity interest, (e.g. common stock, preferred stock, convertible preferred stock, and convertible bonds); as well as derivative instruments that provide stock like returns.

SERS' 2007 Investment Plan targets a long-term allocation of 21.0% of assets to U.S. Stocks. SERS U.S. stock portfolio, in aggregate, will strive to reflect the risk characteristics of the Russell 3000 Index, which is a good proxy for the broad, investable U.S. market.

The large cap segment of the portfolio is benchmarked to the S&P 500 Index utilizing enhanced indexed and transportable alpha strategies including global macro and funds-of-hedge funds. The remainder of the portfolio represents the medium and small capitalization segments of the domestic stock market. Exposure to the medium and small capitalization segment of the market is achieved with actively managed traditional long-only advisors and global macro transportable alpha strategies benchmarked to the Russell 2000 and 2500 Indices.

**Market Value as of December 31, 2006:** U.S. Stocks had a \$9,929.2 million market value, 30.9% of the total fund's \$32,098.2 million market value.

**Number of Investment Advisors:** SERS had contracts with 12 external investment advisors to manage U.S. Stock portfolios.

**Number of Investment Portfolios:** SERS had 13 U.S. Stock portfolios managed by the 12 investment advisors.

**Type of Investment Portfolios:** As of December 31, 2006, 81.9% of SERS U.S. Stock allocation was in large capitalization stock strategies, including the equitized fund-of-hedge funds absolute return strategies, and 18.1% was in medium/small capitalization stock strategies. The alpha transport strategies, used in both the large capitalization and medium/small capitalization segments, replicate a broad market return benchmark through derivatives and then add alpha through uncorrelated return streams. SERS has one equitization manager to replicate the benchmarks for the alpha transport strategies.



# U.S. Stock Investments Summary *(continued)*

U.S. Stock Investment Advisor		Investment Style	Market Value* As of 12/31/06 (\$ Millions)
1.	AQR	Small Cap Global Macro	390.4
2.	AXA Rosenberg Investment Management	Russell 2500, risk controlled	243.9
3.	Barclays Global Investors	Enhanced indexing	\$690.3
4.	Blackstone Alternative Asset Management (BAAM)	Absolute return Fund-of-hedge funds	1,902.4
5.	Bridgewater	Large Cap Global Macro	215.3
	Bridgewater	Small Cap Global Macro	423.7
6.	Emerald	PA stocks	243.3
7.	Iridian Asset Management	Mid-cap private business value	254.6
8.	Mellon Equity Associates	PA stocks	242.6
9.	Mesirow Financial	Absolute return Fund-of-hedge funds	1,630.3
10.	Morgan Stanley Alternative Investment Partners	Absolute return Fund-of-hedge funds	1,398.9
11.	NISA Advisors	Absolute return strategy equitization**	418.2
12.	PAAMCO Absolute Return	Absolute return Fund-of-hedge funds	1,875.2
<b>Total</b>			<b>\$9,929.2</b>

*\*Includes stocks and cash which the manager had available for investment. Numbers may not add due to rounding.*

*\*\*The \$418.2 million balance represents the accrued gain/loss for the equitization of the absolute return fund of funds as of December 31, 2006.*

# Non-U.S. Stock Investments Summary

as of December 31, 2006

Non-U.S. stocks is a component of the stock asset class, one of eight major asset classes that SERS uses to diversify the investments of the Fund. SERS' investment plan diversifies stock investments while maintaining a reasonable risk posture relative to the benchmarks. SERS contracts with external investment advisors to manage portfolios.

**Policy:** Stock investments are employed by the Fund primarily because their expected large return premiums versus inflation will, if realized, help preserve and enhance the real value of the Fund over long periods of time. The Non-U.S. Stock asset class is managed on a total return basis.

SERS' long term investment objective for the non-U.S. stock component of the stock asset class is to achieve a total return, net of fees, that exceeds the total return of the MSCI EAFE Index, a proxy for large cap stocks in non-U.S. developed markets, the S&P/Citigroup Extended Market Index Europe and Pacific, a proxy for small cap stocks in non-U.S. developed markets, and the MSCI Emerging Markets Index, a proxy for stocks in emerging markets.

SERS' 2006 Investment Plan targets an allocation of 5.2% of Fund assets to funds of hedge funds with an EAFE Index swap overlay, 8.4% of Fund assets to stocks in non-U.S. developed markets, 3.4% of Fund assets to strategies dedicated to small-cap stocks in non-U.S. markets, and 4.0% of Fund assets to strategies dedicated to stocks in emerging markets, by the end of 2010.

**Market Value as of December 31, 2006:** Non-U.S. Stocks had a \$6,607.6 million market value, 20.6% of the total Fund's \$32,098.2 million market value. In addition, the fair value of forward exchange contracts in the currency overlay program amounted to (\$27.3) million.

**Number of Investment Advisors:** SERS had contracts with 12 external investment advisors to manage non-U.S. stock portfolios. In addition, SERS had contracts with two external advisors to manage the currency overlay program.

**Number of Investment Portfolios:** SERS had 16 accounts managed by the 12 investment advisors and two accounts for the currency overlay program.

**Type of Investment Portfolios:** As of December 31, 2006, 4.5% of total Fund assets was allocated to funds of hedge funds with an EAFE Index swap overlay, 7.8% of total Fund assets was allocated to stocks in non-U.S. developed markets, 4.2% of total Fund assets was allocated to strategies dedicated to small-cap stocks in non-U.S. markets, and 4.0% was allocated to strategies dedicated to stocks in emerging markets.

# Non-U.S. Stock Investments Summary *(continued)*

Non-U.S. Stock Investment Advisor	Investment Style	Market Value* as of 12/31/06 (\$ millions)
<b>Large Cap</b>		
<b>MSCI EAFE Index swaps and funds of hedge funds</b>		
1. NISA Advisors	MSCI EAFE Equitization	\$97.3
2. Arden Asset Management	Absolute Return Fund-of-funds	677.4
3. Rock Creek Group, LLC	Absolute Return Fund-of-funds	669.2
<b>Traditional large cap non-U.S. developed markets mandates</b>		
4. Artisan Partners Limited Partnership	Growth stocks	707.5
5. Morgan Stanley Investment Management Limited (London)	Free cash flow value	877.9
6. Templeton Investment Counsel, LLC	5-year stock value	919.9
<b>Regional Mandates</b> in liquidation		0.9
<b>Small Cap</b>		
7. Harris Associates L.P.	Small cap - intrinsic value	475.3
8. BlackRock Investment Management International Limited	Small cap - growth	425.2
9. Pictet Asset Management Limited International small cap equity team	Small cap - value with growth	458.3
<b>Emerging Markets</b>		
10. Bernstein Investment Research and Management	Global emerging markets - value	168.2
Pictet Asset Management Limited Emerging markets equity team	Global emerging markets - value	371.5
11. Rexiter Capital Management Limited	Global emerging markets - core	170.7
Templeton Asset Management Ltd. Global emerging markets team TIFI Emerging Markets Series	Global emerging markets - value	370.8
Templeton Asset Management Ltd. Templeton Strategic Emerging Markets Fund team Templeton Strategic Emerging Markets Fund, L.P.	Global emerging markets private placements with public companies	0.4
Templeton Strategic Emerging Markets Fund II, L.P.	Global emerging markets private placements with public companies	70.6
12. Oaktree Capital Management, LLC OCM Emerging Markets Feeder Fund, L.P.	Pacific basin emerging and developed - long/short	146.5
<b>Total Non-U.S. Stocks</b>		<b>\$6,607.6</b>

\*Includes stocks and cash which the manager had available for investment. Numbers may not add due to rounding.

\*\*The \$97.3 million balance represents the accrued gain/loss for the equitization of the absolute return fund of funds as of December 31, 2006

## Non-U.S. Stock Investments Summary *(continued)*

<b>Currency Overlay Investment Advisor</b>	<b>Investment Style</b>	<b>Market Value* as of 12/31/06 (\$ millions)</b>
1. Pareto Partners	currency overlay	\$(17.0)
2. Record Treasury	currency overlay	(10.3)
<b>Total Currency Overlay</b>		<b>(27.3)</b>
<b>Total Non-U.S. and Currency Overlay</b>		<b>\$6,580.3</b>

*\*Includes stocks and cash which the manager had available for investment. Numbers may not add due to rounding*

# Fixed Income Investments Summary

as of December 31, 2006

Fixed Income is one of eight major asset classes that SERS uses to diversify the investments of the Fund. The SERS' Investment Plan diversifies Fixed Income investments and strategies. SERS contracts with external investment advisors to manage portfolios.

**Policy:** The Fixed Income asset class is employed by the Fund because of its ability to generate current income from interest payments, increase the value of the Fund through the reinvestment of those interest payments, serve as a Benefit Payment Reserve during periods of financial stress, serve as a hedge against disinflation and/or deflation and to help diversify the overall Fund. The Fixed Income asset class is managed on a total return basis.

In the Fixed Income asset class, SERS' long-term investment objective is to achieve a total return, net of fees, that exceeds the total return of the SERS Custom Fixed Income Index which is comprised of the Lehman Intermediate, Lehman Aggregate, the Citigroup High Yield Market and J.P. Morgan Emerging Market Bond indices.

SERS' 2006 Investment Plan targets a long-term allocation of 24.0% of assets of the total Fund to the Fixed Income asset class. Of this amount, 63% is targeted to the core strategies and 37% to specialty strategies (high-yield and emerging market debt).

**Market Value as of December 31, 2006:** Fixed Income had a \$4,911.9 million market value, 15.3% of the total Fund's \$32,098.2 million market value.

**Number of Investment Advisors:** SERS had contracts with 16 external investment advisors to manage portfolios within the Fixed Income asset class as of December 31, 2006.

**Number of Investment Portfolios:** SERS had a total of 18 portfolios within the Fixed Income asset class.

**Type of Investment Portfolios:** The Fixed Income asset class is divided into core and specialty segments.

**Core:** Core portfolios invest in relatively liquid, high quality, fixed income securities with intermediate term durations that meet return, disinflation/deflation, high quality liquidity and diversification needs of the Fund. SERS had five actively managed core bond portfolios; three Lehman Intermediate actively managed portfolios, two Lehman Aggregate actively managed portfolios with a market value of \$1,845.0 million and one passively managed core bond portfolio with a market value of \$267.4 million. The combination of core portfolios represented 43.0% of the asset class.

**Specialty:** The specialty strategy portfolios (high-yield, emerging market debt, whole-loan mortgages, subordinated debt, and mezzanine debt) focus on debt instruments offering higher return premiums and different risk characteristics than core fixed income securities. SERS has corporate high yield portfolios with a market value of \$1,160.9 million, emerging market debt portfolios with a market value of \$1,318.5 million, one high yield commercial mortgage-backed securities portfolio with a market value of \$304.5 million, one whole-loan mortgage portfolio with a market value of \$6.3 million, one subordinated debt portfolio with a market value of \$5.2 million that invests in Pennsylvania companies, and one mezzanine debt portfolio with a market value of \$4.1 million. The specialty portfolios represent 57.0% of the asset class.

# Fixed Income Investments Summary *(continued)*

	<b>Fixed Income Investment Advisor</b>	<b>Investment Style</b>	<b>Market Value* As of 12/31/06 (\$ Millions)</b>
<b>Core</b>			
1.	Goldman Sachs Asset Management	Active domestic intermediate duration	\$388.2
2.	MDL Capital Management	Active domestic intermediate duration	95.8
3.	Standish (Mellon)	Domestic – index	267.4
4.	Morgan Stanley	Active domestic	865.4
5.	NISA Investment Advisors	Active domestic intermediate duration	390.3
6.	Taplin, Canida & Habacht	Active domestic	105.4
<b>Specialty</b>			
7.	Legg Mason	Whole–loan mortgages	6.3
8.	Berwind (Eureka) Financial Group	PA Capital Fund	5.2
9.	Oaktree Capital Management	Mezzanine Fund	4.1
10.	Fidelity Management Trust Company	Commercial mortgage backed securities	304.5
11.	W. R. Huff Asset Management	High yield bonds	485.4
12.	Stone Harbor (Salomon)	Global High yield	675.4
	Stone Harbor (Salomon)	Emerging Market Debt	402.1
13.	Ashmore AEMDF	Emerging Market Debt (\$U.S.)	233.0
	Ashmore LCD	Emerging Market Debt – Local	149.7
14.	Gramercy Advisors	Emerging market debt –absolute return	113.9
15.	Greylock Capital Management	Emerging market debt –absolute return	110.5
16.	PIMCO	Emerging market debt	309.4
<b>Total</b>			<b>\$4,911.9</b>

*\*Includes securities and cash that the manager had available for investment. Numbers may not add due to rounding.*

# Cash Investments Summary

as of December 31, 2006

Cash is one of eight major asset classes that SERS uses for investments of the Fund. The SERS' Investment Plan calls for minimizing cash balances while meeting cash flow requirements.

**Policy:** Cash investments are employed by the Fund to provide for SERS' liquidity needs and to accumulate funds for future permanent investment. The Cash asset class is to be managed on a total return basis, with the exception that temporary investments such as overnight repurchase agreements ("repo"), commercial paper, and banker's acceptance may alternatively be evaluated on a yield-to-maturity basis given their extremely short maturities.

In the Cash asset class, SERS' long term investment objectives are to achieve a total return, net of fees, that exceeds the total return on 90 day U.S. Treasury Bills. SERS' current Investment Plan targets an allocation of 0% of assets to the Cash asset class.

**Market Value as of December 31, 2006:** Cash had a \$380.6 million market value, 1.2% of the total Fund's \$32,098.2 million market value.

**Number of Investment Advisors:** In accordance with SERS' 2006 Investment Plan, SERS utilizes the Pennsylvania State Treasury Department to manage its cash accounts.

**Number of Investment Portfolios:** SERS' cash portfolio is managed primarily by the Treasurer.

**Type of Investment Portfolios:** SERS Cash asset class currently employs a money market short-term investment strategy. The portfolio also contains the uninvested cash balances held by other SERS investment advisors in other asset classes.

In the aggregate, the State Treasury managed approximately \$572 million on behalf of SERS and SERS' external investment advisors as of December 31, 2006.

# Real Estate Investments Summary

as of December 31, 2006

Equity Real Estate is one of eight major asset classes that SERS uses to diversify the investments of the Fund. SERS' investment plan diversifies Real Estate investments and balances real estate management styles. In accordance with the plan, SERS contracts with external investment advisors to manage portfolios.

**Policy:** Equity Real Estate investments are generally long-term, illiquid investments that due to their high correlation with inflation provide an inflation hedge and, due to their low correlation with stocks and bonds, provide diversification within the total portfolio. It is expected that the long-term total return (income and appreciation) for real estate will fall between that of stocks and bonds. The Equity Real Estate asset class is managed on a total return basis.

In the Equity Real Estate asset class, SERS' long-term investment objective is to achieve a total net return that exceeds the total return of the NCREIF Index for rolling five year periods. SERS' 2006 Investment Plan targets a long-term allocation of 8% of assets to the Equity Real Estate asset class.

Investments are made through commingled fund investments, limited partnerships, REITs and separate account portfolios where SERS contracts with external investment advisors to own properties directly or with other co-investors. SERS' Equity Real Estate portfolio provides for diversification by:

- Transaction structure;
- Property type;
- Geographic location; and
- Development phase.

**Market Value as of December 31, 2006:** Real Estate had an estimated \$2,529.9 million market value, approximately 7.9% of the total Fund's December 31, 2006 market value. This market value represents September 30, 2006 actual numbers adjusted for cash flows, which occurred in the fourth quarter 2006. Real estate market values and detailed property data is lagged by one quarter due to the timing of the receipt of the private market valuations and information.

**Number of Investment Advisors:** SERS had contracts with 25 external investment advisors to manage real estate portfolios as of September 30, 2006.

**Number of Investment Portfolios:** SERS had investments in 55 real estate portfolios managed by the 25 investment advisors.

**Type of Investment Portfolios:** As of September 30, 2006, the composition of the real estate portfolio was:

- 31% pooled funds, 69% separate accounts
- 25% office, 6% industrial, 7% retail, 21% residential, 13% hotel/motel, 7% timber, 21% other
- 13% Pennsylvania, 23% East excluding PA, 30% West, 15% South, 5% Midwest, 14% International
- 33% of the market value of the separate accounts was invested in sixteen investments located in Pennsylvania.



# Real Estate Investments Summary *(continued)*

	<b>Real Estate Investment Advisor</b>	<b>SERS Initial Funding</b>	<b>Property Type</b>	<b>Transaction Structure</b>	<b>Market Value* as of 9/30/06 (\$ millions)</b>
1.	Apollo – AREF III	06/26/98	Opportunistic	equity and debt	\$32.0
2.	Berwind – BPG Fund IV	04/20/98	Opportunistic	equity and debt	4.5
	BPG Fund V	11/29/99	Opportunistic	equity and debt	16.0
	BPG Fund VI	09/09/02	Opportunistic	equity and debt	21.1
	BPG Fund VII	09/12/05	Opportunistic	equity and debt	12.5
3.	Blackstone – BREP III	10/22/99	Opportunistic	equity and debt	4.7
	BREP IV	12/08/03	Opportunistic	equity and debt	20.9
	BREP V	01/24/06	Opportunistic	equity and debt	17.8
4.	Campbell Group		Timber	equity ownership	-
5.	Cliffwood Select Equity Fund	08/04/00	Long/Short REITs	public securities	41.5
6.	ING Real Estate Securities	01/31/96	REITs	public securities	465.6
7.	Filmore Capital Partners	06/29/06	Debt	equity and debt	9.2
8.	Forest Investment Assoc.	10/30/92	Timber	equity ownership	168.5
9.	Hawkeye Partners – Scout Fund		Opportunistic	equity and debt	-
10.	Heitman Capital Mgmt	12/28/87	Diversified	equity ownership	60.0
11.	LaSalle Investment Mgmt	10/01/93	Diversified	equity ownership	213.5
12.	Grosvenor Investment Mgmt.	10/01/93	PA diversified	equity ownership	236.9
	Eastern Retail Holdings	01/07/99	Retail	equity and debt	0.6
13.	Lowe Enterprises	10/01/93	Diversified	equity ownership	416.8
14.	Lubert-Adler Fund II	10/30/98	Opportunistic	equity and debt	11.8
	Lubert-Adler Fund III	11/10/00	Opportunistic	equity and debt	14.0
	Lubert-Adler Fund IV	03/31/04	Opportunistic	equity and debt	22.0
	Lubert-Adler Fund V	04/10/06	Opportunistic	equity and debt	3.3
15.	Miller Global Fund III	01/19/99	Diversified	equity and debt	1.0
16.	Oaktree Capital Management:				
	TCW Fund VI	04/20/94	Opportunistic	equity and debt	0.4
	OCM Opportunity Fund A	05/09/96	Opportunistic	equity and debt	10.7
	OCM Opportunity Fund II	12/15/98	Opportunistic	equity and debt	6.0
	OCM Opportunity Fund III	03/05/03	Opportunistic	equity and debt	30.0
17.	Oxford Development	01/09/97	Industrial	equity ownership	0.2
	Oxford Fund		Development	equity and debt	-
18.	Prudential - Senior Housing I	12/22/98	Senior housing	equity and debt	1.8
	Senior Housing II	06/12/01	Senior housing	equity and debt	31.1
	Senior Housing III	01/12/06	Senior housing	equity and debt	13.7
	Mexico Retail Fund	09/19/06	Opportunistic	equity and debt	10.1
19.	Rockpoint Group - Fund I	09/28/04	Opportunistic	equity and debt	20.1
	Rockpoint Fund II	09/27/05	Opportunistic	equity and debt	13.8
	Finance Fund		Opportunistic	equity and debt	-
20.	Sentinel Corp.	07/31/84	Diversified	equity ownership	78.0
21.	Starwood: SOF IV	03/24/97	Opportunistic	equity and debt	5.0
	SOF V	05/14/99	Opportunistic	equity and debt	3.7
	SOF VI	03/27/03	Opportunistic	equity and debt	52.5
	SOF VII	01/13/06	Opportunistic	equity and debt	12.4

# Real Estate Investments Summary *(continued)*

	<b>Real Estate Investment Advisor</b>	<b>SERS Initial Funding</b>	<b>Property Type</b>	<b>Transaction Structure</b>	<b>Market Value* as of 9/30/06 (\$ millions)</b>
22.	UBS-Brinson: PMSA	09/30/83	Diversified	equity mortgages	70.1
	RESA	06/3//84	Diversified	equity ownership	82.2
	Multifamily Trust	08/02/99	Residential	equity ownership	1.0
23.	Urdang Investment Mgmt.	05/15/02	REITs	public securities	64.6
24.	Westbrook Partners: WREF II	06/16/97	Opportunistic	equity and debt	6.8
	WREF III	09/01/98	Opportunistic	equity and debt	8.3
	WREF IV	05/01/01	Opportunistic	equity and debt	12.2
	WREF V	02/16/05	Opportunistic	equity and debt	18.6
	WREF VI	05/10/06	Opportunistic	equity and debt	8.9
	WREF VII		Opportunistic	equity and debt	-
25.	Goldman Sachs: Whitehall V&VI	04/20/94	Opportunistic	equity and debt	2.6
	Whitehall V-S & VI-S	12/11/95	Opportunistic	equity and debt	0.2
	Whitehall VII & VIII	05/28/96	Opportunistic	equity and debt	2.9
<b>September 30, 2006 Total</b>					<b>\$2,362.1</b>
<b>4<sup>th</sup> Quarter 2006 Net Cash Flow Adjustments</b>					<b>+ 167.8</b>
<b>December 31, 2006 Total</b>					<b>\$2,529.9</b>

*Numbers may not add due to rounding.*

*\*Market values are lagged by one quarter due to the timing of the receipt of private market valuations and information.*

# Alternative Investments Summary

as of December 31, 2006

Alternative Investments is comprised of Venture Capital and Private Equity investments, both of which take the form of limited partnerships, and is one of eight major asset classes that SERS uses to diversify the investments of the fund.

## Venture Capital and Private Equity Defined

Venture Capital is the financing of young, rapidly growing companies, typically at three stages of development. (1) Seed and Early Stage: Seed is the form of venture capital that supports companies in their conceptual phase, i.e., a product and market are identified, and a corporation may have been formed. Early Stage financing supports companies pursuing a business plan but not yet generating meaningful revenues. The product has been developed and may have been shipped to customers for testing. Management positions have been filled and an operating team is in place. (2) Late Stage financing supports companies that have proven revenues, and are in the process of rolling out operations and building sales to achieve profitability. (3) Growth or Expansion financing supports profitable or nearly profitable businesses that, lacking access to significant debt financing, need capital for growth and expansion. Companies at either the later stage or growth or expansion stage may be nearing a strategic sale to another company or an initial public offering.

Private Equity primarily refers to investments in the equity and subordinated debt of established companies. Private equity approaches undertaken by SERS' limited partnerships include: (1) Leveraged buyouts and management buyouts in which companies are acquired through the use of borrowed funds, or a combination of borrowed funds and contributed equity capital. The acquired company's assets serve as collateral for the borrowed funds, which are repaid from the company's cash flows. (2) Distressed debt investing involves: (a) deleveraging of debt-laden, but successful, companies by infusing capital to permit debt reduction in exchange for an equity stake in the company, or (b) acquiring debt of a troubled, sometimes bankrupt company, at steep discounts to face value, followed by assistance to return the company to profitability to permit selling of the debt securities at levels above the discounted purchase price. (3) Secondary interests in established private equity funds – these interests are purchased from other investors who seek liquidity or desire to realign or rebalance their investment portfolios, often for non-financial reasons. Such partnership interests can be purchased at significant discounts to net asset value and often occur when the acquired partnerships begin to realize profits.

**Investment Objective:** SERS' long term investment objective for Alternative Investments is to achieve a risk-adjusted total return, net of fees, in excess of the return generated by the S&P 500 Index. SERS' 2006-2007 Investment Plan anticipates a long-term allocation range with a midpoint of 14%.

**Market Value as of December 31, 2006:** The asset class total market value stood at \$4,223.4 million after adjusting the September valuation for subsequent cash flows in the 4<sup>th</sup> quarter. Alternative investment market values lag one quarter due to timing of the receipt of private market valuations, reports and other information. These values do not include 4<sup>th</sup> quarter unrealized appreciation/depreciation. Alternative investments represent 13.2% of the Fund. Sub-asset class market values and fund percentages were as follows:

	Unfunded Commitments (\$ mil)	Market Value (\$ mil)	Percent of Total Fund
Venture Capital	\$931.3	\$1,094.2	3.4%
Private Equity	2,899.3	3,129.2	9.8%
Total Alternative Investments	\$3,830.6	\$4,223.4	13.2%

# Alternative Investments Summary *(continued)*

**Number of Limited Partnerships:** As of December 31, 2006, SERS had commitments to 294 active Alternative Investments limited partnerships, 111 to Venture Capital partnerships and 183 to Private Equity partnerships. (This does not include twenty five partnerships – seventeen Venture Capital and eight Private Equity – that are now “inactive,” or in the liquidation phase, and investments pending contract approval.)

**Portfolio:** SERS’ Alternative Investment program’s scope has expanded over the years to include top investment funds nationally and internationally. The program holds indirect investment interests in approximately 4,000 companies. The Venture Capital program includes investments working to commercialize novel solutions to current and future challenges in information technology, communications, and medicine. In addition to direct fund investments, the venture capital program includes investments in several funds-of-funds. A fund-of-funds is a limited partnership that, in turn, invests in other limited partnerships. Five of these fund-of-funds commitments have the strategic goal of enabling SERS to gain indirect exposure to many top-tier venture capital funds that SERS would otherwise have difficulty accessing directly. Another two of these commitments are to funds investing in minority-focused venture capital funds. The remaining fund-of-funds commitments target region specific and emerging market funds.

The Private Equity program invests in buyout, distressed, international, and secondary oriented partnerships. Buyout transactions are privately negotiated or result from investment bank sponsored auctions, and are usually completed with present management in place; hostile acquisitions are generally avoided. Distressed investment managers employ differentiated strategies, i.e., they employ control or non-control approaches, and accordingly, have differing degrees of active influence over the companies in which they invest. European funds are attempting to capitalize on trends favoring the restructuring of large companies, generational succession in businesses established after World War II, and cross-border business opportunities within the region since the formation of the European Economic Union and currency harmonization. Asian investments focus on the expanded opportunities in the region created by attractive valuations, favorable demographic trends, economic growth, and changing attitudes in many Asian countries regarding foreign investment. The portfolio’s exposure to other energy markets is also expanding. Additionally, SERS utilizes one manager to oversee stock distributions.

**Alternative Investment Portfolio Allocation:** The Alternative Investment program is well-diversified by stage of investment, industry focus, and geography. As of September 30, 2006, based on market value, the program was allocated as follows:

## By Sub Sector:

U.S. Private Equity	48.3%
U.S. Venture Capital	22.8%
International	13.9%
Distressed/Opportunistic	7.2%
Pennsylvania	5.7%
Other	2.1%

## By Style:

LBO	37.8%
Expansion Stage	16.8%
Early Stage	11.5%
Start-Up	9.7%
Senior Debt LBO	5.5%
Acquisition/Platform	6.1%
Other	12.6%

## By Industry:

Communications	23.9%
Consumer	19.8%
Healthcare	15.5%
Manufacturing	7.6%
Financial	9.0%
Software	7.9%
Electronics	4.4%
Energy	3.4%
Other	8.5%

## By Geography:

U.S. Northeast	17.7%
U.S. Mid-Atlantic	8.4%
U.S. West Coast	14.9%
U.S. Other	28.8%
United Kingdom	6.1%
Germany	3.3%
Scandinavia	3.2%
Rest of World	17.6%

# Venture Capital Committed, Drawn and Distributed

as of September 30, 2006

The Capital Committed column represents total dollars allocated from SERS to each limited partnership. Capital Drawn is the portion of SERS capital commitments drawn by the General Partner to be invested with underlying portfolio companies. The Distributions column shows the value of original capital and profits returned to SERS.

	Active Venture Capital Funds Limited Partnership	Financing Stage Focus	SERS Initial Funding	Capital Committed	Capital Drawn	Distributions
1	APAX Excelsior VI	Later Stage	7/3/2000	\$35,000,000	\$32,846,153	\$21,063,976
2	APEX Investment Fund IV	Early Stage	8/31/1999	25,000,000	25,000,000	257,565
3	APEX Investment Fund V	Early Stage	7/25/2001	20,000,000	16,600,000	729,846
4	Abingworth Bioventures IV, L.P.	Seed/Early Stage	7/16/2003	20,000,000	11,900,000	0
5	Adams Capital Management II	Early Stage	9/30/1999	30,000,000	30,000,000	0
6	Adams Capital Management III	Early Stage	10/25/2000	30,000,000	24,450,000	4,761,905
7	Advanced Technology Ventures VI	Early Stage	3/9/2000	10,000,000	9,750,000	240,896
8	Advanced Technology Ventures VII LP	Early Stage	12/6/2000	27,000,000	18,697,200	3,370,102
9	Alloy Annex I, L.P.	Seed/Early Stage	7/16/2003	5,000,000	3,000,000	0
10	Alloy Ventures 2000 L.P.	Early Stage	4/26/2000	20,000,000	18,000,000	2,074,620
11	Alloy Ventures 2002 LP	Early Stage	3/20/2002	25,000,000	15,250,000	2,602,018
12	Alloy Ventures 2005, L.P.	Seed/Early Stage	7/13/2005	25,000,000	5,500,000	0
13	Artiman Ventures II, L.P.	Seed/Early Stage	*	25,000,000	0	0
14	Atlas Venture Fund IV	Early Stage	3/23/1999	26,000,000	22,880,753	4,579,621
15	Atlas Venture Fund V L.P.	Early Stage	1/28/2000	37,200,000	36,125,920	5,454,623
16	Atlas Venture Fund VI	Early Stage	1/24/2001	24,800,000	20,014,447	2,199,824
17	Austin Ventures IX	Early Stage	1/26/2005	20,932,140	1,857,142	0
18	Austin Ventures VIII	Early Stage	1/29/2001	20,932,140	17,298,477	2,539,024
19	Bachow Investments III	Later Stage	11/9/1994	25,000,000	25,073,149	25,267,385
20	Birchmere Ventures III	Early Stage	3/18/2004	10,000,000	3,976,524	0
21	Care Capital Investments III, L.P.	Later Stage	12/14/2005	25,000,000	1,250,000	0
22	Charles River Partnership XI LP	Early Stage	1/31/2001	11,032,259	8,770,646	1,120,980
23	Clearstone Venture Partners III-A, L.P.	Early/Late Stage	4/21/2004	25,000,000	9,250,000	0
24	Cross Atlantic Technology Fund	Early Stage	2/14/2000	20,000,000	19,749,041	2,866,261
25	Cross Atlantic Technology Fund II	Early Stage	12/28/2001	32,900,000	28,952,000	2,460,790
26	Devon Park Bioventures, L.P.	Early/Late Stage	*	20,000,000	0	0
27	Draper Fischer Jurvetson VI	Early Stage	8/13/1999	8,000,000	7,640,000	94,810
28	Draper Fisher Jurvetson Fund VII LP	Early Stage	7/26/2000	20,000,000	16,181,716	2,224,687
29	Draper Triangle Ventures	Early Stage	8/31/1999	20,000,000	20,924,608	2,150,823
30	Draper Triangle Ventures II, L.P.	Early Stage	9/10/2003	12,000,000	2,274,987	0
31	Edison Venture Fund III	Later Stage	3/1/1994	25,000,000	25,000,000	45,769,784
32	Fairview Capital	Fund of Funds	9/28/1994	10,000,000	10,000,000	4,434,328
33	Fairview II	Fund of Funds	3/1/1998	10,000,000	9,600,000	2,420,297
34	Frazier Healthcare III	Early Stage	2/4/1999	30,000,000	28,575,000	5,645,014
35	Frazier Healthcare IV	Early Stage	3/14/2001	30,000,000	21,342,010	3,569,576
36	Frazier Healthcare V	Early/Late Stage	12/8/2004	30,000,000	5,775,000	0
37	Grotech PA III	Later Stage	6/29/1990	3,000,000	3,014,865	2,910,452
38	Grotech Partners IV	Later Stage	11/1/1993	25,000,000	25,157,827	44,089,796

# Venture Capital Committed, Drawn and Distributed *(continued)*

	Active Venture Capital Funds Limited Partnership	Financing Stage Focus	SERS Initial Funding	Capital Committed	Capital Drawn	Distributions
39	Grotech Partners V	Later Stage	9/18/1998	\$25,000,000	\$25,125,000	\$22,628,391
40	Halpern Denny Fund II	Later Stage	4/23/1998	25,000,000	25,116,871	4,513,556
41	Halpern Denny Fund III	Later Stage	4/26/2000	25,000,000	23,056,740	15,103,708
42	HarbourVest Partners VI	Fund of Funds	5/7/1999	200,000,000	162,586,055	39,806,920
43	HarbourVest Partners VII	Fund of Funds	4/24/2002	75,000,000	28,125,000	1,113,750
44	HarbourVest Partners VIII	Fund of Funds	*	100,000,000	0	0
45	Healthcare Ventures III	Early Stage	7/9/1992	15,000,000	15,000,000	30,778,200
46	Healthcare Ventures V	Early Stage	10/17/1997	25,000,000	24,312,500	51,302,628
47	Healthcare Ventures VI	Early Stage	6/19/2000	35,000,000	34,125,000	3,462,611
48	Healthcare Ventures VII	Early Stage	7/24/2002	35,000,000	21,437,500	0
49	Healthcare Ventures VIII, L.P.	Early Stage	7/13/2005	30,000,000	3,600,000	0
50	Highland Capital Partners VI	Early Stage	10/25/2000	25,000,000	18,937,500	13,246,314
51	Highland Capital Partners VII	Early Stage	*	35,000,000	0	0
52	IP II L.P.	Early Stage	12/17/2001	8,600,000	6,692,074	1,006,296
53	IP III, L.P.	Seed/Early Stage	10/27/2004	8,000,000	2,940,000	0
54	InterWest Partners IX, L.P.	Early Stage	7/14/2004	20,000,000	4,000,000	0
55	InterWest Partners VIII L.P.	Early Stage	8/25/2000	25,000,000	21,250,000	5,323,829
56	J.H. Whitney Equity Fund III LP	Later Stage	3/12/1998	20,000,000	20,171,316	37,142,836
57	J.H. Whitney IV LP	Later Stage	2/1/2000	20,000,000	16,712,208	1,596,861
58	J.P. Morgan Venture Capital Investors	Fund of Funds	7/8/1999	100,000,000	93,928,649	13,319,035
59	JMI Equity Fund V, L.P.	Early/Late Stage	6/10/2005	24,000,000	10,853,205	0
60	JP Morgan Venture Capital Investors II	Fund of Funds	8/23/2000	100,000,000	60,244,224	9,127,321
61	JP Morgan Venture Capital Investors III	Fund of Funds	12/7/2005	100,000,000	1,989,609	3,580
62	Keystone V	Later Stage	12/26/1997	25,000,000	25,117,132	2,082,064
63	Keystone Venture IV	Later Stage	7/13/1993	15,000,000	15,045,275	11,249,174
64	Kline Hawkes Pacific LP	Early Stage	8/30/2000	15,000,000	14,574,282	3,676,068
65	Knightbridge Venture Capital VI, L.P.	Fund of Funds	4/21/2004	20,000,000	2,600,000	0
66	Lightspeed Venture Partners VII, L.P.	Early Stage	12/7/2005	18,000,000	1,332,045	0
67	Meritech Capital Partner III, L.P.	Later Stage	7/13/2005	35,000,000	5,775,000	0
68	Meritech Capital Partners II	Later Stage	10/25/2000	24,600,166	20,101,451	6,845,826
69	Mid-Atlantic III	Early Stage	4/1/1997	20,008,308	20,111,247	4,465,817
70	Mid-Atlantic Venture Fund IV L.P.	Early Stage	5/4/2000	30,000,000	26,400,000	217,297
71	Morgenthaler Partners VII L.P.	Early Stage	7/26/2001	35,000,000	26,250,000	3,977,583
72	Morgenthaler Partners VIII, L.P.	Diversified	4/27/2005	35,000,000	7,000,000	0
73	NEPA Venture-II	Early Stage	7/24/1992	7,500,000	7,526,234	34,796,288
74	New Enterprise Associates 11	Early Stage	10/29/2003	25,000,000	16,250,000	2,665,232
75	New Enterprise Associates 12	Diversified	4/26/2006	35,000,000	1,404,833	0
76	New Enterprise Associates IX	Early Stage	10/28/1999	20,000,000	19,600,000	2,330,761
77	New Enterprise Associates VI	Early Stage	3/2/1994	25,000,000	25,000,000	196,734,032
78	New Enterprise Associates X LP	Early Stage	9/13/2000	35,000,000	30,653,000	11,587,795
79	New Enterprises Associates VII	Early Stage	4/1/1997	30,000,000	30,000,000	97,217,571
80	Novo Vita	Early Stage	10/25/2000	11,616,498	11,363,996	61,064
81	Oak Investment Partners XI	Later Stage	6/9/2004	35,000,000	26,610,295	2,503,779
82	Oak Investment Partners XII	Early/Late Stage	7/6/2006	40,000,000	4,686,390	0



# Venture Capital Committed, Drawn and Distributed *(continued)*

Active Venture Capital Funds Limited Partnership	Financing Stage Focus	SERS Initial Funding	Capital Committed	Capital Drawn	Distributions
83 P/A Fund I	Later Stage	6/2/1993	\$30,000,000	\$29,999,999	\$64,201,030
84 P/A Fund III	Later Stage	4/1/1997	100,000,000	100,000,000	151,420,448
85 PA Early Stage Partners III L.P.	Early Stage	6/6/2001	10,000,000	4,200,000	0
86 Polaris Venture Partners	Early Stage	6/4/1996	15,000,000	14,595,000	46,501,899
87 Polaris Venture Partners II	Early Stage	9/8/1998	25,000,000	24,750,000	24,859,455
88 Polaris Venture Partners III L.P.	Early Stage	1/6/2000	50,000,000	46,000,000	13,041,838
89 Polaris Venture Partners IV L.P.	Early Stage	7/31/2001	50,000,000	38,000,000	0
90 Polaris Venture Partners V	Diversified	1/25/2006	50,000,000	1,500,000	0
91 Quaker Bio Ventures	Early Stage	2/25/2003	20,000,000	11,922,957	1,291,707
92 Sofinnova Venture Partners VII, L.P.	Early Stage	*	20,000,000	0	0
93 Sprout VII	Early Stage	2/24/1995	18,000,000	18,000,000	34,604,446
94 Summit Accelerator Fund L.P.	Early Stage	11/15/1999	8,000,000	7,320,000	4,061,865
95 Summit IV	Later Stage	6/27/1995	25,000,000	24,250,000	182,561,331
96 Summit Partners VC II L.P.	Diversified	4/27/2005	15,000,000	975,000	0
97 Summit V	Later Stage	3/1/1998	37,500,000	35,812,500	40,680,554
98 T.Rowe Price	Stock Distribution	1/3/2005	0	168,439,563	103,739,636
99 TA/Advent VIII	Later Stage	2/3/1997	30,000,000	29,541,093	51,649,099
100 TL Ventures III LP	Early Stage	1/3/1997	15,000,000	15,062,614	18,874,357
101 TL Ventures IV	Early Stage	5/13/1999	35,000,000	35,000,000	7,974,759
102 TL Ventures V	Early Stage	7/13/2000	40,000,000	27,648,219	2,969,489
103 Three Arch Capital LP	Early Stage	12/20/2000	20,000,000	16,450,000	3,145,142
104 Three Arch Partners IV, L.P.	Early/Late Stage	9/10/2003	20,000,000	4,500,000	465,004
105 US Venture Partners VII LP	Early Stage	1/24/2000	13,750,000	13,087,500	638,812
106 US Venture Partners VIII LP	Early Stage	12/6/2000	26,250,000	21,463,125	2,762,215
107 Weston Presidio II	Later Stage	11/27/1995	20,000,000	17,000,000	41,383,116
108 Weston Presidio III	Later Stage	3/31/1999	35,000,000	31,237,086	20,994,821
109 Weston Presidio IV	Later Stage	6/21/2000	35,000,000	31,207,752	12,127,743
110 Weston Presidio V	Later Stage	12/8/2004	50,000,000	9,100,000	0
111 Worldview Technology Partners IV	Early Stage	1/31/2001	18,130,023	15,120,043	1,907,983
<b>Total Active VC Commitments</b>			<b>\$3,262,751,534</b>	<b>\$2,331,464,547</b>	<b>\$1,656,641,939</b>

*\*Not Funded as of 9/30/06*

*Commitments as of 12/31/06*

*Cash flows as of 9/30/06*

## Inactive Venture Capital Funds

Limited Partnership	Capital Committed	Capital Drawn	Distributions
<b>Total Inactive Venture Capital</b>	<b>\$114,700,000</b>	<b>\$107,276,929</b>	<b>\$275,431,540</b>

# Private Equity Committed, Drawn and Distributed

as of September 30, 2006

The Capital Committed column represents total dollars allocated from SERS to each limited partnership. Capital Drawn is the portion of SERS capital commitments drawn by the General Partner to be invested with underlying portfolio companies. The Distributions column shows the value of original capital and profits returned to SERS.

	Active Private Equity Funds Limited Partnership	Financing Stage Focus	SERS Initial Funding	Capital Committed	Capital Drawn	Distributions
1	ABACUS Fund Partners L.P.	Hedge Fund	4/24/2000	\$15,000,000	\$15,149,220	\$8,131,989
2	ABRY Broadcast Partners III	Buyouts	4/1/1997	25,000,000	27,013,555	21,852,484
3	ABRY Broadcast Partners IV LP	Buyouts	7/26/2000	35,000,000	27,603,837	28,614,628
4	ABRY Mezzanine Partners	Mezzanine	12/5/2001	30,000,000	30,844,559	11,727,676
5	ABRY Partners V, L.P.	Buyouts	10/27/2004	45,000,000	14,780,925	272,411
6	ABRY Senior Equity II, L.P.	Mezzanine	1/25/2006	30,000,000	3,275,127	0
7	ABS Capital Partners III L.P.	Buyouts	1/26/1999	35,000,000	29,705,650	15,910,364
8	ABS Capital Partners IV L.P.	Buyouts	10/13/2000	35,000,000	31,048,249	17,129,164
9	ABS Capital Partners V, L.P.	Buyouts	11/14/2005	20,000,000	4,734,049	0
10	AG Capital Recovery Partners II LP	Distressed Debt	10/1/2001	17,600,000	17,695,470	26,494,566
11	AG Capital Recovery Partners III LP	Distressed Debt	3/20/2002	20,000,000	16,000,000	24,819,042
12	AG Capital Recovery Partners IV LP	Distressed Debt	1/23/2003	50,000,000	35,415,216	42,985,501
13	AG Capital Recovery Partners V, L.P.	Distressed Debt	1/25/2006	20,000,000	4,600,000	0
14	APAX Europe IV L.P.	Buyouts	3/31/1999	35,000,000	29,445,670	20,968,215
15	APAX Europe V LP	Buyouts	12/6/2000	60,000,000	64,413,049	77,570,053
16	APAX Europe VI, L.P.	Later Stage	10/27/2004	60,000,000	50,699,826	8,369,693
17	APAX Germany II	Middle/Later Stage	7/15/1997	8,737,262	8,455,477	16,916,389
18	APAX UK Ventures VI	Middle/Later Stage	12/9/1997	6,558,000	6,861,111	12,302,931
19	AXA Secondary Fund III	Secondaries	11/19/2004	26,000,000	11,801,475	9,161,998
20	AXA Secondary Fund III-2	Secondaries	11/29/2004	14,000,000	6,143,919	4,999,420
21	AXA Secondary Fund IV	Secondaries	*	80,000,000	0	0
22	Abingworth Bioventures V, L.P.	Early Stage	*	33,775,000	0	0
23	Accel Europe L.P.	Early Stage	7/2/2001	15,000,000	7,300,000	0
24	Alpha Private Equity Fund 4 L.P.	Mid Market Buyouts	1/23/2002	26,580,000	34,973,099	37,028,356
25	Alpha Private Equity Fund 5, L.P.	Mid Market Buyouts	12/14/2005	60,194,500	7,711,625	0
26	Apollo Investment Fund IV	Buyouts	8/3/1998	75,000,000	73,952,122	69,777,395
27	Apollo Investment Fund V	Buyouts	4/18/2001	50,000,000	53,343,540	51,779,988
28	Apollo Investment Fund VI, L.P.	Buyouts	9/14/2005	40,000,000	4,273,977	0
29	Asia Pacific Growth Fund III	Global Situations	3/8/1999	15,000,000	15,171,945	4,658,746
30	Audax Private Equity Fund II, L.P.	Mid Market Buyouts	4/27/2005	25,000,000	7,123,799	41,559
31	Audax Private Equity Fund L.P.	Mid Market Buyouts	5/25/2000	35,000,000	34,732,061	35,226,888
32	Avenue Asia Special Situations Fund IV, LP	Distressed Debt	4/26/2006	50,000,000	2,664,750	6,587
33	Avenue Special Situations Fund III, L.P.	Distressed Debt	7/16/2003	50,000,000	42,428,808	46,369,581
34	Avenue Special Situations Fund IV, L.P.	Distressed Debt	8/29/2005	50,000,000	34,686,804	0
35	B III Capital Partners	Distressed Debt	8/1/1997	35,000,000	34,503,390	47,650,729
36	BC European Capital VII LP	Buyouts	7/27/2000	37,345,000	35,046,584	38,005,838
37	BC European Capital VII Top Up	Buyouts	3/14/2001	12,090,549	11,246,070	7,732,853
38	BC European Capital VIII, L.P.	Buyouts	1/26/2005	97,635,000	7,044,526	0
39	Bain Capital Fund IX, L.P.	Buyouts	3/15/2006	75,000,000	21,375,000	0



# Private Equity Committed, Drawn and Distributed *(continued)*

Active Private Equity Funds Limited Partnership		Financing Stage Focus	SERS Initial Funding	Capital Committed	Capital Drawn	Distributions
40	Bain Capital Fund VII	Buyouts	7/6/2000	\$25,000,000	\$24,062,500	\$21,321,757
41	Bain Capital Fund VIII-E, L.P.	Buyouts	9/15/2004	13,405,000	6,912,043	477,177
42	Bain Capital IX Coinvestment Fund	Buyouts	3/15/2006	15,000,000	2,325,000	0
43	Berkshire Fund VI LP	Mid Market Buyouts	9/28/2001	20,000,000	13,976,251	9,322,844
44	Berkshire Fund VII	Mid Market Buyouts	*	32,000,000	0	0
45	Blackstone Capital II	Buyouts	8/26/1994	40,000,000	42,827,676	92,799,317
46	Blackstone Capital III	Buyouts	11/3/1997	75,000,000	74,178,299	91,205,625
47	Blackstone Capital IV	Buyouts	10/31/2001	75,000,000	70,870,100	57,435,480
48	Blackstone Capital Partners V, L.P.	Buyouts	9/14/2005	150,000,000	25,391,527	8,722
49	Blackstone Communications Partners I LP	Buyouts	8/29/2000	25,000,000	26,330,314	14,764,341
50	Brait IV, L.P.	Buyouts	*	25,000,000	0	0
51	Brynwood Partners V, L.P.	Mid Market Buyouts	7/31/2005	10,000,000	4,856,219	0
52	Centerbridge Capital Partners I, L.P.	Buyouts	9/26/2006	50,000,000	598,054	0
53	Cerberus Institutional Partners L.P.	Distressed Debt	3/5/1999	35,000,000	35,000,000	63,510,332
54	Cerberus Institutional Partners Series Three	Distressed Debt	9/10/2003	35,000,000	13,921,354	1,697,911
55	Cerberus Institutional Partners Series Two	Distressed Debt	10/9/2001	35,000,000	30,100,793	45,330,256
56	Cerberus Institutional Partners Series Four	Distressed Debt	*	75,000,000	0	0
57	Charterhouse Capital Partners VII	Buyouts	12/4/2002	50,000,000	50,373,671	28,358,807
58	Charterhouse Capital Partners VIII	Diversified	1/26/2006	72,161,102	10,745,511	0
59	Charterhouse Equity Partners II	Buyouts	3/30/1994	40,000,000	43,849,172	100,462,834
60	Charterhouse Equity Partners III	Buyouts	11/19/1997	50,000,000	55,395,586	42,613,033
61	Chequers Capital XV, L.P.	Buyouts	3/15/2006	42,315,000	3,631,883	0
62	Chrysalis Capital Partners, L.P.	Distressed Debt	3/16/2005	20,000,000	3,000,000	519,632
63	Clayton Dubilier & Rice V	Buyouts	5/3/1995	50,000,000	49,601,504	49,826,483
64	Clayton Dubilier & Rice VI	Buyouts	1/4/1999	50,000,000	37,673,182	17,741,863
65	Code Hennessy & Simmons	Buyouts	9/28/1989	10,000,000	9,650,000	27,208,717
66	Code Hennessy & Simmons II	Buyouts	7/12/1994	20,000,000	20,000,000	50,245,995
67	Code Hennessy & Simmons III	Buyouts	8/1/1997	40,000,000	38,724,000	53,983,600
68	Code Hennessy & Simmons IV	Mid Market Buyouts	8/31/1999	100,000,000	96,270,000	77,348,153
69	Code Hennessy & Simmons Equity V, L.P.	Mid Market Buyouts	9/15/2004	50,000,000	16,716,110	0
70	Cognetas Fund II, L.P.	Buyouts	1/26/2005	52,072,000	13,850,442	0
71	DLJ Merchant Banking Fund II	Buyouts	5/22/1997	75,000,000	80,615,348	90,041,814
72	DLJ Merchant Banking Fund III	Buyouts	6/6/2001	85,000,000	91,501,061	87,789,940
73	Elevation Partners, L.P.	Private Equity	10/27/2004	35,000,000	10,705,973	0
74	Energy Spectrum Partners IV, L.P.	Mid Market Buyouts	11/15/2004	50,000,000	25,821,022	0
75	Eureka II, L.P.	Mid Market Buyouts	9/14/2005	20,000,000	6,056,425	0
76	Excelsior Capital Asia Partners III, L.P.	Middle/Later Stage	3/15/2006	25,000,000	535,139	0
77	First Reserve Fund X, L.P.	Buyouts	1/15/2004	30,000,000	21,737,555	10,293,701
78	First Reserve Fund XI	Buyouts	*	60,000,000	0	0
79	Francisco Partners II, L.P.	Buyouts	3/15/2006	30,000,000	1,725,000	0
80	Francisco Partners LP	Buyouts	5/8/2000	50,000,000	45,734,586	16,137,883
81	Frontenac VII	Buyouts	8/1/1997	40,000,000	40,000,000	54,428,513
82	GTC&R V	Buyouts	4/25/1997	11,400,000	11,400,000	17,085,761
83	GTC&R VI	Buyouts	6/25/1998	50,000,000	50,854,013	41,095,935
84	GTC&R VII	Buyouts	3/15/2000	55,000,000	47,427,796	57,747,464

# Private Equity Committed, Drawn and Distributed *(continued)*

	Active Private Equity Funds Limited Partnership	Financing Stage Focus	SERS Initial Funding	Capital Committed	Capital Drawn	Distributions
85	GTCR VIII	Buyouts	5/12/2003	\$75,000,000	\$57,750,000	\$29,845,283
86	GTCR IX, L.P.	Early Stage	*	50,000,000	0	0
87	Great Hill Equity Partners	Buyouts	4/12/1999	30,000,000	29,775,000	24,612,347
88	Great Hill Equity Partners II LP	Buyouts	7/26/2000	35,000,000	33,425,000	42,681,832
89	Great Hill Equity Partners III, L.P.	Mid Market Buyouts	1/25/2006	35,000,000	7,612,500	0
90	Gryphon Partners II LP	Buyouts	8/6/1999	35,000,000	35,881,393	27,582,490
91	Gryphon Partners III, LP	Buyouts	6/9/2004	30,000,000	8,437,050	1,484,758
92	HIPEP V-Asia Pacific & Rest of World Ptr. Fund	Buyouts	4/26/2006	30,000,000	2,745,316	0
93	Hancock IPEP II (Harbourvest II)	Fund of Funds	4/1/1997	25,000,000	24,357,775	29,592,145
94	HarbourVest Inter III	Fund of Funds	6/22/1998	40,000,000	37,200,000	25,068,683
95	Harbourvest Intl' Private Equity Partners IV	Fund of Funds	12/6/2000	40,000,000	27,600,000	10,728,585
96	Hellman & Friedman II	Global Situations	1/7/1992	21,130,323	23,218,222	39,807,943
97	Hellman Friedman III	Global Situations	6/14/1995	50,000,000	40,308,123	91,378,863
98	Hellman Friedman IV	Global Situations	8/3/1999	75,000,000	66,540,777	78,466,964
99	Hellman Friedman V	Diversified	8/1/2004	80,000,000	51,117,717	2,537,894
100	Hellman & Friedman VI	Buyouts	*	125,000,000	0	0
101	InterMedia Partners VII, LP	Diversified	*	15,000,000	0	0
102	Invemed Catalyst Fund L.P.	Mid Market Buyouts	9/30/1999	25,000,000	13,216,624	1,407,460
103	J.H. Whitney V LP	Later Stage	9/13/2000	20,000,000	19,298,665	14,858,105
104	J.H. Whitney VI, L.P.	Buyouts	1/26/2005	50,000,000	13,694,245	0
105	J.W. Childs Equity Partners III L.P.	Mid Market Buyouts	1/23/2002	40,000,000	33,370,036	9,250,905
106	JP Morgan US Corp Finance Investors II	Fund of Funds	7/24/2002	50,000,000	26,883,802	5,850,769
107	Kelso Investment Associates V	Buyouts	1/26/1994	40,000,000	54,411,479	144,929,426
108	Kelso VI	Buyouts	7/7/1998	75,000,000	69,057,922	71,914,227
109	Kelso VII	Buyouts	2/11/2004	40,000,000	18,072,390	2,078,471
110	LLR Equity Partners II, L.P.	Buyouts	1/29/2004	25,000,000	9,237,377	2,013,889
111	LLR Equity Partners LP	Mid Market Buyouts	1/24/2000	25,000,000	24,341,235	27,665,873
112	Landmark Equity IV	Secondaries	2/28/1995	14,923,291	12,880,353	17,992,121
113	Landmark Equity Partners V	Secondaries	1/27/1996	19,624,113	19,434,947	22,954,499
114	Leeds Weld Equity Partners IV, L.P.	Mid Market Buyouts	7/30/2004	20,000,000	11,144,645	0
115	Lexington Capital Partners II	Secondaries	4/1/1998	40,000,000	39,538,000	38,889,029
116	Lexington Capital Partners III L.P.	Secondaries	1/26/1999	35,000,000	34,010,028	32,827,205
117	Lexington Capital Partners V	Secondaries	7/25/2001	75,000,000	65,790,788	45,578,578
118	Lexington Capital Partners VI, L.P.	Secondaries	8/12/2005	50,000,000	5,307,628	4,560
119	Lime Rock Partners III, L.P.	Growth Equity	10/27/2004	15,000,000	7,559,921	0
120	Lime Rock Partners IV, L.P.	Growth Equity	*	25,000,000	0	0
121	Lime Rock Resources, L.P.	Diversified	12/7/2005	20,000,000	4,583,591	0
122	Madison Dearborn Capital Partners	Buyouts	2/23/1993	15,000,000	14,538,849	41,226,794
123	Madison Dearborn Capital Partners IV	Buyouts	10/27/2000	90,000,000	76,869,714	25,525,602
124	Madison Dearborn Capital Partners V	Buyouts	2/16/2006	75,000,000	281,250	0
125	Madison Dearborn Capital Partners II	Buyouts	1/3/1997	40,000,000	40,152,017	84,292,693
126	Madison Dearborn III	Buyouts	4/6/1999	75,000,000	76,194,907	75,225,652
127	Matlin Patterson Global Opportunities II	Distressed Debt	12/3/2003	30,000,000	22,629,233	3,492,128
128	MatlinPatterson Global Opportunities Partners	Distressed Debt	5/4/2001	35,000,000	33,613,973	32,681,917
129	Media/Communication III	Buyouts	6/2/1997	25,000,000	24,131,061	25,539,613

# Private Equity Committed, Drawn and Distributed *(continued)*

	Active Private Equity Funds Limited Partnership	Financing Stage Focus	SERS Initial Funding	Capital Committed	Capital Drawn	Distributions
130	Media/Communications IV	Buyouts	2/5/1999	\$25,000,000	\$23,125,000	\$3,333,333
131	Media/Communications Ventures Fund V LP	Buyouts	7/26/2000	35,000,000	30,829,565	10,435,283
132	Meridian Venture Partners II, L.P.	Buyouts	1/26/2005	10,000,000	8,750,000	823,344
133	New York Life Capital Partners III, L.P.	Secondaries	5/31/2006	50,000,000	5,415,733	0
134	Newbridge Asia II L.P.	Buyouts	9/3/1999	15,000,000	15,199,629	13,250,716
135	Newbridge Asia III LP	Buyouts	7/6/2000	15,000,000	15,015,979	4,526,177
136	Newbridge Asia IV LP	Buyouts	6/1/2005	40,000,000	16,321,973	79,575
137	Nordic Capital V L.P.	Buyouts	12/4/2002	40,000,000	40,787,212	15,251,232
138	Nordic Capital VI, L.P.	Buyouts	10/26/2005	72,588,000	3,852,343	0
139	OCM Opportunities Fund	Distressed Debt	1/12/1996	24,000,000	24,534,457	34,577,066
140	OCM Opportunities Fund II	Distressed Debt	2/5/1998	40,000,000	40,099,999	54,580,932
141	OCM Opportunities Fund III	Distressed Debt	1/20/2000	60,000,000	60,007,890	83,101,369
142	OCM Opportunities Fund IV	Distressed Debt	12/31/2001	70,000,000	68,250,000	114,041,812
143	OCM Opportunities Fund V	Distressed Debt	7/14/2004	40,000,000	40,003,507	43,836
144	OCM Opportunities Fund VI, L.P.	Distressed Debt	9/14/2005	40,000,000	30,000,000	0
145	OCM Principal Opportunities	Distressed Debt	11/12/1996	25,000,000	25,057,879	28,026,126
146	OCM Principal Opportunities II	Distressed Debt	3/14/2001	25,000,000	25,000,000	30,050,243
147	OCM/GFI Power Opportunities Fund II, L.P.	Buyouts	4/27/2005	25,000,000	3,777,862	29,205
148	Oakhill Capital Partners	Buyouts	5/17/1999	50,000,000	52,236,073	42,965,636
149	Oaktree Capital Management LLC	Diversified	5/28/2004	20,000,000	20,577,053	2,995,368
150	Palamon European Equity II, L.P.	Diversified	6/14/2005	40,114,200	5,369,178	0
151	Palamon European Equity L.P.	Buyouts	7/23/1999	30,000,000	32,265,087	25,358,926
152	Parthenon Investors II	Mid Market Buyouts	9/25/2001	20,000,000	18,322,527	13,440,054
153	Permira European Fund	Buyouts	7/1/1997	36,000,000	32,159,947	70,324,495
154	Permira European Fund II	Buyouts	6/7/2000	50,000,000	43,846,362	59,807,717
155	Permira European Fund III, L.P.	Buyouts	10/3/2003	112,640,170	64,752,241	23,852,391
156	Permira IV, L.P.	Buyouts	*	126,870,000	0	0
157	Permira UK Venture Fund III	Middle/Later Stage	8/29/1989	9,063,438	8,946,988	26,106,191
158	Permira UK Venture Fund IV	Middle/Later Stage	4/2/1996	15,000,000	15,993,572	22,367,105
159	Pitango Venture Capital Fund IV, LP	Diversified	4/21/2004	20,000,000	8,801,534	0
160	Providence Equity Partners IV LP	Middle/Later Stage	10/25/2000	25,000,000	27,235,356	25,955,025
161	Providence Equity Partners V LP	Mid Market Buyouts	7/14/2004	50,000,000	28,961,398	188,442
162	Providence Equity Partners VI, L.P.	Buyouts	*	50,000,000	0	0
163	RRZ Private Equity	Buyouts	11/7/1996	20,000,000	20,246,562	10,848,280
164	SCP Private Equity Partners II L.P.	Buyouts	6/15/2000	25,000,000	21,971,188	2,127,951
165	ShoreView Capital Partners	Buyouts	4/23/2003	38,000,000	24,892,468	24,338,599
166	Siguler Guff BRIC Opportunities Fund, L.P.	Fund of Funds	3/15/2006	10,000,000	2,058,299	103,717
167	Sterling Capital Partners II	Buyouts	3/16/2005	30,000,000	6,754,100	0
168	Sterling Capital Partners LP	Buyouts	10/15/2002	15,000,000	8,332,317	3,007,772
169	Summit Partners Private Equity Fund VII L.P.	Buyouts	4/27/2005	97,134,500	4,856,725	0
170	Summit Ventures VI LP	Later Stage	1/11/2001	62,000,000	58,912,929	27,850,577
171	TA/Advent IX	Later Stage	9/20/2000	45,000,000	43,650,000	28,161,536
172	TA/Advent X	Middle/Later Stage	1/25/2006	70,000,000	4,900,000	0
173	TPG Partners II	Buyouts	5/2/1997	75,000,000	76,477,220	77,544,171
174	TPG Partners III	Buyouts	12/15/1999	75,000,000	69,112,892	93,687,348

# Private Equity Committed, Drawn and Distributed *(continued)*

	Active Private Equity Funds Limited Partnership	Financing Stage Focus	SERS Initial Funding	Capital Committed	Capital Drawn	Distributions
175	TPG Partners IV	Buyouts	12/3/2003	\$30,000,000	\$23,024,120	\$9,347,065
176	TPG Partners V	Buyouts	4/26/2006	100,000,000	1,113,009	0
177	Thomas H. Lee Equity Fund IV LP	Buyouts	4/24/1998	70,000,000	63,844,603	47,761,305
178	Thomas H Lee Equity Fund V LP	Buyouts	7/1/2000	100,000,000	101,252,737	56,575,328
179	Thomas H. Lee Equity Fund VI, L.P.	Mid Market Buyouts	*	50,000,000	0	0
180	UMS Partners Fund I, L.P.	Distressed Debt	7/14/2004	5,000,000	5,000,000	0
181	Vestar Capital Partners III	Buyouts	5/7/1997	25,000,000	23,152,400	18,182,623
182	Vestar Capital Partners IV L.P.	Mid Market Buyouts	11/22/1999	100,000,000	92,345,592	56,548,174
183	Vestar Capital Partners V, L.P.	Mid Market Buyouts	9/14/2005	50,000,000	6,842,067	0
<b>Total Active Private Equity Commitments</b>				<b>\$7,727,956,448</b>	<b>\$4,828,658,718</b>	<b>\$4,198,892,282</b>

*\*Not funded as of 9/30/06.*

*Commitments as of 12/31/06*

*Cash flows as of 9/30/06*

## Inactive Private Equity Funds

	Limited Partnership	Capital Committed	Capital Drawn	Distributions
<b>Total Inactive Private Equity</b>		<b>\$67,700,000</b>	<b>\$68,303,179</b>	<b>\$126,269,030</b>

# Inflation Protection Investments Summary

as of December 31, 2006

Inflation Protection is one of eight major asset classes that SERS uses for investments of the Fund. The objective of this asset class is to reduce the deleterious affects of inflation by investing in strategies that specifically respond to expected and unexpected inflation.

**Policy:** Inflation Protection investments are employed by the Fund to provide diversification within the total portfolio and to act as a hedge against inflation.

SERS' long term investment objective in the inflation protection asset class is to achieve a total return, net of fees, that exceeds the total return of the Customized Inflation Protection Benchmark.

The strategy is a combination of indexed commodities, Treasury Inflation Protection Securities (TIPS) and a diversified inflation hedges portfolio. The strategy provides diversification and low correlations to other asset classes in the portfolio. The commodities are based on the Goldman Sachs Commodity Index (GSCI) which is a "basket" of 24 commodities that are traded on U.S. exchanges. Exposure to the GSCI is achieved through swap contracts. The underlying cash for the GSCI swaps is invested in intermediate-duration TIPS. These fixed-income securities adjust for actual changes in inflation, and therefore retain their real value. The prices of these investments are expected to generally move independently of the broad market movements that affect other financial assets. Commodities historically have the highest correlation with inflation, considerably outperforming stocks and bonds during rising inflation periods, but underperforming when inflation was stable or falling. They provide an inflation hedge because their prices are linked to global supply and demand conditions for the world's basic commodities. This is the general underlying driver of inflation.

SERS' 2006 Investment Plan targeted a long-term allocation of 7.0% of assets to Inflation Protection. The commodity allocation includes passively managed exposure to the commodity markets. This exposure is gained by entering into swap agreements that provide the GSCI return that would be achieved by passively holding the underlying commodity futures contracts. The TIPS generate higher incremental return above typical cash instruments. On December 31, 2006, the passive commodity portfolio had a long term target of 5.0% of the total Fund. The active strategy over/under weights inflation-sensitive instruments including commodities, inflation-sensitive stocks, and bonds. The active diversified inflation hedge portfolio has a long term target of 2.0% of the total Fund.

**Market Value as of December 31, 2006:** Inflation protection strategies had a \$1,958.1 million market value, 6.1% of the total Fund's \$32,098.2 million market value on December 31, 2006.

**Number of Investment Advisors:** SERS had contracts with two external investment advisors to manage the Inflation Protection portfolios.

**Number of Investment Portfolios:** SERS had Inflation Protection portfolios managed by the two investment advisors.

**Types of Investment Portfolios:** The inflation protection asset class utilizes a passive commodity portfolio that achieves the commodity index return by employing a swap agreement and represents 64% of the asset class. The actively managed portfolio represents 36% of the asset class.

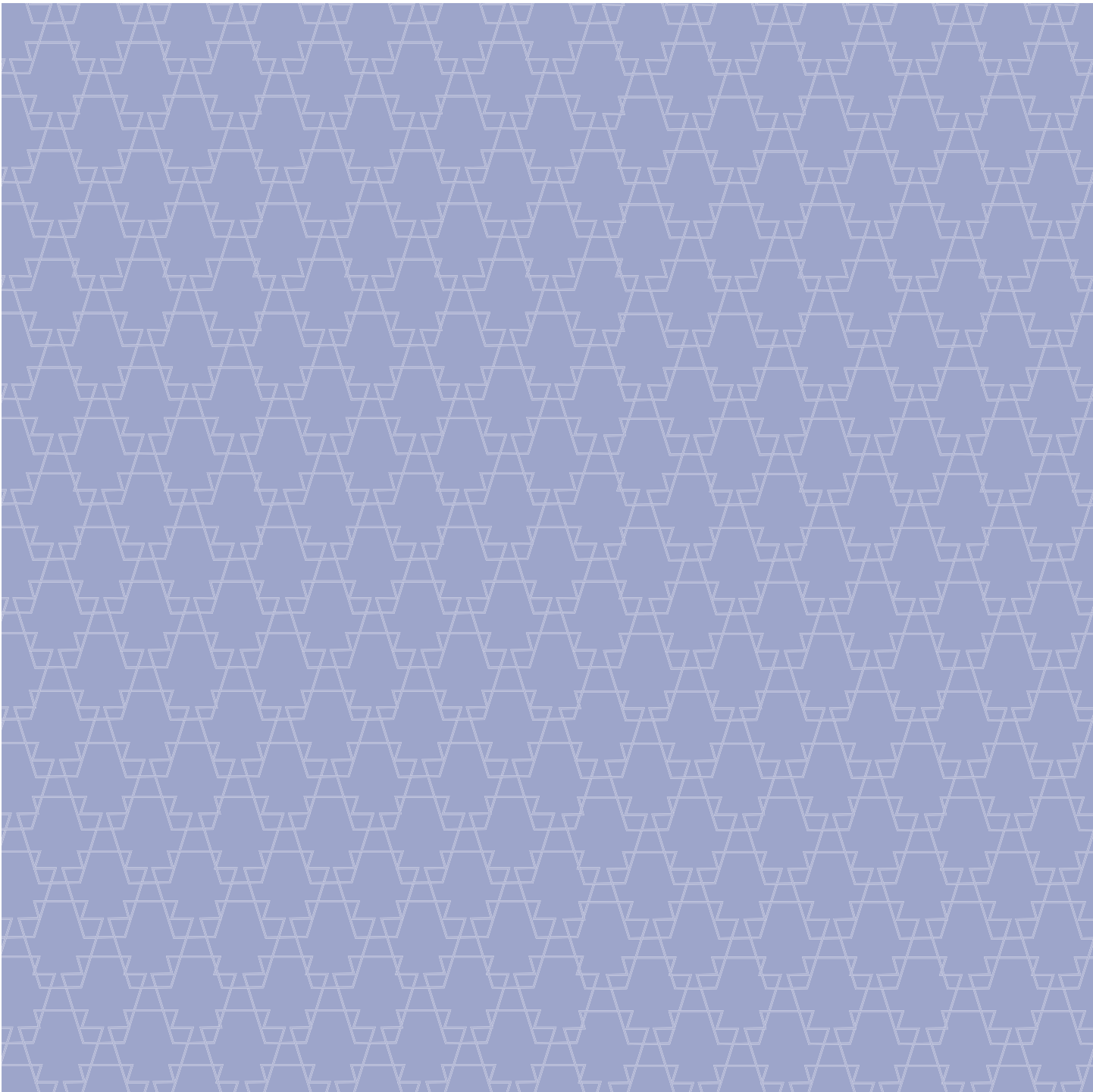
The diversified inflation hedge portfolio seeks to add value from both bottom-up selection of global equity, fixed income, and commodities instruments, as well as active top-down asset class and sector allocation.

# Inflation Protection Investments Summary *(continued)*

	<b>Inflation Protection Investment Advisor</b>	<b>Investment Style</b>	<b>Market Value* As of 12/31/06 (\$ Millions)</b>
1.	NISA Investment Advisors	Indexed commodities and TIPS	\$1,249.9
2.	Wellington	diversified inflation hedge portfolio	708.2
	<b>Total</b>		<b>\$1,958.1</b>

*Numbers may not add due to rounding.*

*\*Includes securities and cash that the manager had available for investment.*



# Pennsylvania Investments Summary



# Pennsylvania Investments Summary

as of December 31, 2006

The State Employees' Retirement System's Board, employees of SERS and agents of the Board stand in a fiduciary relationship to the members and beneficiaries of the System regarding the investments and disbursements of the Fund. Subject to "prudent investor" investment responsibilities contained in the Retirement Code and the Fiscal Code, the Board has exclusive control and management of the Fund and full power to invest the assets of the Fund. The Board adopted a formal Statement of Investment Policy in 1979, which was last revised effective October 27, 2004 to reflect and incorporate subsequent legislative and policy changes governing investments. Where investment characteristics including yield, risk and liquidity are equivalent, the Board's policy favors investments that have a positive impact on the economy of Pennsylvania.

The most significant impact the Fund can have on the State's economy is to manage an overall program that achieves a fully funded status and lowers the employer contributions to the Fund below the normal cost. The Fund has been successful in these endeavors, maintaining a well funded status since 1992 and reducing the employer contributions from over 18% in 1981 to the current rate of 4.02%. These reduced employer contributions below the actuarial normal cost projections saved the taxpayers in excess of \$2 billion. The reduction of such contributions may then be used by the legislature for purposes it deems most important to Pennsylvania citizens and taxpayers, such as tax reduction, economic development or other priorities. Nevertheless, the Fund also seeks to invest in State-based companies and other State entities when investment characteristics are equivalent.

**Market Value of Pennsylvania Investments as of December 31, 2006:** SERS' assets had an unaudited market value in Pennsylvania investments of approximately \$1,445.2 million on December 31, 2006 (4.5% of SERS' total fund).

## SERS Pennsylvania Investments By Asset Class (In \$ millions)

Asset Class	Total PA Market Value
Stocks	\$446.5
Fixed Income	90.0
Real Estate	311.4
Venture Capital	112.4
Private Equity	484.9
<b>Total</b>	<b>\$1,445.2</b>

SERS investment portfolios have historically held investments in Pennsylvania firms, as some large national firms are headquartered in the Pittsburgh, Philadelphia and Harrisburg areas, including Hershey Foods, Cigna Corp., Rohm & Haas Co., and H. J. Heinz Co. In addition, SERS has invested in portfolios that are designed to give emphasis to investments in Pennsylvania while meeting the fiduciary standards mentioned previously.

### Stocks

SERS has two Pennsylvania stock portfolios that increase exposure to "in-state" corporations. SERS' Pennsylvania stock universe is comprised of 314 publicly-traded corporations which:

- 1) name their headquarters as Pennsylvania and have Pennsylvania employees or operations; or
- 2) have Pennsylvania-based employment exceeding 25% of total corporate employment. Emerald Advisers, Inc. of Lancaster and Mellon Equity Associates of Pittsburgh actively manage portfolios principally derived from SERS' Pennsylvania stock universe. The market value of SERS' two Pennsylvania stock funds was \$485.9 million as of December 31, 2006. The list on the following page were some of the top-performing Pennsylvania stocks for the year-to-date ending December 31, 2006:



# Pennsylvania Investments Summary *(continued)*

Company	Location	December 2006
<b>Mothers Work</b>	<b>Philadelphia</b>	<b>208.2%</b>
Mothers Work designs, manufactures, and retails maternity clothes. The Company operates a chain of maternity apparel stores throughout the United States.		
<b>Allegheny Technologies</b>	<b>Pittsburgh</b>	<b>152.9%</b>
Allegheny Technologies produces specialty materials. The Company's products include stainless steel, nickel and cobalt based alloys, and tungsten-based specialty materials.		
<b>Ampco-Pittsburgh Corporation</b>	<b>Pittsburgh</b>	<b>134.1%</b>
Ampco-Pittsburgh Corporation manufactures engineered equipment. The Company produces finned tube heat exchange coils, large standard and custom air handling systems, hardened steel rolls, and heat transfer rolls. Ampco's products are used in the construction, power generation, and steel industries.		
<b>Dollar Financial Corporation</b>	<b>Berwyn</b>	<b>132.2%</b>
Dollar Financial Corporation provides check-cashing, short-term consumer loans, money orders, and money transfers through its network of company operated stores. The Company operates in the United States, Canada, and the United Kingdom.		
<b>C-COR, Incorporated</b>	<b>State College</b>	<b>129.2%</b>
C-COR, Incorporated offers broadband transport products and systems for voice, video, and data delivery. The Company is a provider of optical packets and digital video telecommunication transport products, end-to-end fiber systems, and technical field services.		
<b>Universal Stainless &amp; Alloy</b>	<b>Bridgeville</b>	<b>123.2%</b>
Universal Stainless & Alloy manufactures and markets semi-finished and finished specialty steel products, including stainless steel, tool steel, and certain other alloyed steels. The Company's products are sold to re-rollers, forgers, service centers, and original equipment manufacturers.		
<b>West Pharmaceutical Services</b>	<b>Lionville</b>	<b>107.4%</b>
This Company applies value-added services to the process of bringing new drug therapies and healthcare products to global markets. The Company's technologies include the design and manufacture of packaging components, research and development of drug delivery systems, and contract laboratory services.		
<b>American Eagle Outfitters</b>	<b>Warrendale</b>	<b>105.9%</b>
American Eagle Outfitters retails men's and women's casual apparel, footwear, outerwear, and accessories. The Company's products include jeans, T-shirts, and other similar apparel.		
<b>Interdigital Communications Corp.</b>	<b>King of Prussia</b>	<b>83.1%</b>
Interdigital Communications develops technology for advanced digital wireless telecommunications applications. The Company offers both proprietary and standards compliant digital wireless technology to customers, licensees, and companies.		
<b>The Bon-Ton Stores</b>	<b>York</b>	<b>81.7%</b>
The Bon-Ton Stores sells moderately priced, brand name fashions and accessories for men, women, and children. The Company also sells cosmetics, jewelry, china, housewares, and other items through its chain department stores.		

# Pennsylvania Investments Summary *(continued)*

In addition to the two Pennsylvania stock portfolios with Pennsylvania stocks amounting to \$398.8, SERS also had an additional \$47.7 million invested in the stock of Pennsylvania companies as of December 31, 2006. These stocks were held in SERS' S&P 500 Alpha Tilts fund and in SERS actively managed portfolios providing a total of \$446.5 million invested in Pennsylvania companies.

## Fixed Income

In 1998, the SERS Board approved the funding for the Pennsylvania Capital Fund with a \$50 million allocation committed to the program. The program commenced in March 1999 managed by Berwind Financial Group (Berwind) and PNC Equity Management (PNC). Each advisor was awarded commitments of \$25 million to be invested over four years. Both entities matched SERS' investment. The program provides debt financing to support the expansion and growth of Pennsylvania small business. The Fund seeks to lend to established, profitable, companies in good financial condition with annual revenues between \$10 - \$100 million. The majority of the Fund's investments had a maturity of between five and ten years. Loan amounts usually ranged from \$2 million to \$15 million. As of December 31, 2006, SERS' portion of Berwind investments totaled \$5.2 million while PNC investments had matured and all capital was returned to SERS during the fourth quarter of 2005. Some of Berwind's investments have also matured and the capital was distributed back to SERS. Examples of some of SERS' investments through The Pennsylvania Capital Fund as of December 31, 2006 are:

- Berwind invested \$0.5 million in redeemable preferred stock from Maxima Technologies & Systems, Inc. of Lancaster. Maxima Technologies is a full-service, global manufacturing company specializing in vehicle instrumentation, components, controls, and accessories.
- Berwind invested \$2.15 million in redeemable preferred stock from Elite Health Solutions, Inc of Mechanicsburg. Elite Health Solutions provides portable x-ray and related mobile diagnostics services primarily at nursing homes and correctional facilities.

As of December 31, 2006, SERS had \$6.3 million invested in Pennsylvania mortgages through Legg Mason. The commercial mortgages are for a community shopping center located in Lewistown, Pa. (Mifflin County Commons). It is estimated that as of December 31, 2006, the various commercial projects financed within the Commonwealth by SERS under the commercial mortgage program have directly employed thousands of Pennsylvania workers during the life of the program. This figure does not take into account those who are employed in the property management and maintenance areas of these projects, nor does it consider the favorable "ripple effect" that such jobs may have on the local economy.

Additionally, SERS had approximately \$63.9 million invested as of December 31, 2006, in corporate securities issued by Pennsylvania-based companies. These securities are held in SERS' various externally managed bond portfolios.

## Cash

SERS is one of the largest investors in the Pennsylvania State Treasury Department's Short Term Investment Pool.

## Real Estate

In 1987 SERS began investing directly in the Pennsylvania commercial real estate market and subsequently established two separate account real estate portfolios managed by Heitman Capital Management and Grosvenor Investment Management, formerly Legg Mason Real Estate Services (LMRES), with a Pennsylvania focus. The Heitman separate account had a requirement to invest on a best efforts basis 50% of its initial allocation within the Commonwealth while the LMRES account is focused primarily on investing within the state.

# Pennsylvania Investments Summary *(continued)*

As of September 30, 2006, the SERS real estate portfolio contained 66 Pennsylvania properties totaling 9.8 million square feet ("s.f.") of office, retail, and warehouse space, and 4,665 apartment, hotel and senior housing units. The gross market value of the Pennsylvania real estate portfolio investments totaled \$1,336 million, of which SERS' ownership share was \$311.4 million. The portfolio contains numerous notable Pennsylvania real estate investments:

- **30 N. Third Street** – SERS owns a 100% interest in this major downtown Harrisburg office building, which contains 200,000 s.f. of office space. The building serves as both an investment for SERS and as SERS' headquarters, in addition to providing office space for other businesses with operations in the city.
- **79 North Industrial and Research Park** – This investment, located in Allegheny County, consists of seven industrial buildings with a total of 473,578 s.f. and 23.4 acres of buildable land.
- **Koppers Building** – SERS acquired this 356,439 s.f. 34-story landmark office building located in downtown Pittsburgh in May 1997.
- **Park Ridge One and Two** – These two five-story suburban Pittsburgh office buildings total 206,279 s.f.
- **General Residential Holdings** – Under the oversight of Grosvenor, SERS has invested with a local developer in eight separate land holdings in the Philadelphia area. To date, five of the parcels have been sold.
- **Lehigh Valley Industrial** – In August 1998 SERS began investing in the purchase of prime industrial parcels located in the Lehigh Valley area, with the guidance of Grosvenor and a local operator.
- **Kinzua Management Unit** – In July 1998 SERS invested in 18,602 acres of hardwood timberland located in seven Pennsylvania counties and one New York county, all within the Allegheny region. Subsequently, in the first quarter of 1999 an additional 2,197 acres of Pennsylvania timberland was purchased. The existing SERS timberland manager, Forest Investment Associates, manages these holdings.

# Pennsylvania Investments Summary *(continued)*

## Real Estate Separate Account Pennsylvania Properties as of September 30, 2006\*

Property	Location	Description	Net Market Value (\$ millions)	Manager
1. 30 North Third St.	Harrisburg	10-story office building containing 193,000 s.f.	\$21.2	Heitman Capital Management
2. Hampton Inn	Monroeville	Hotel participation and land lease	4.5	Grosvenor Investment Management
3. I-79 North Industrial Park	Allegheny County	7 industrial buildings containing 473,578 sf in a self-contained park	19.5	Grosvenor Investment Management
4. Koppers Building	Pittsburgh	356,439 s.f. office	19.8	Grosvenor Investment Management
5. General Residential Holdings	Chester County	Residential land development	9.8	Grosvenor Investment Management
6. Lehigh Valley Industrial	Lehigh Valley	Industrial land development	1.6	Grosvenor Investment Management
7. Park Ridge One & Two	Pittsburgh	Two office bldgs, total s.f. 206,479	12.1	Grosvenor Investment Management
8. Toll Brothers Realty Trust	Huntington Valley	Private REIT	46.2	Grosvenor Investment Management
9. Toll Brothers Realty Trust II	Huntington Valley	Private REIT	18.0	Grosvenor Investment Management
10. 1180 Church Road	Lansdale	455,000 s.f. office/ warehouse	24.6	Grosvenor Investment Management
11. Alcoa Bus. Center	Pittsburgh	229,000 s.f. office bldg	15.7	Grosvenor Investment Management
12. Dewey Homes Gty	Philadelphia	Gty to Bank for land	8.1	Grosvenor Investment Management
13. Station Square	Lansdale	348 Multifamily units	14.4	Grosvenor Investment Management
14. Courtyard by Marriott	Collegeville	130 room hotel	8.0	Grosvenor Investment Management
15. Heritage of Green Hills	Reading	Development of 619 unit Sr. Hsg. facility	13.1	Grosvenor Investment Management
16. Kinzua Mgmt Unit	Various PA counties	Timber	67.5	Forest Investment Associates
<b>Total</b>			<b>\$304.1<sup>1/</sup></b>	

\* Real estate market values and detailed property data lags by one quarter due to the timing of the receipt of private market valuations and information. "Separate Account" denotes assets that are owned by entities controlled by SERS.

<sup>1/</sup> Net Market Value exclusive of property leverage. Grosvenor Investment Management also uses portfolio debt which equaled \$14 million at 9/30/06.

## Alternative Investments

SERS' venture capital program dates back to 1985. Initially the program targeted a 1% allocation to venture capital with a focus to invest with managers located in Pennsylvania or with managers who had a Pennsylvania investment mandate. Over its 20-year life the program has grown to include national and international private equity and venture capital managers, and the target allocation to alternative investments has grown to 14.0%. Although the program has become more global, the number of managers investing in companies that impact Pennsylvania via income tax revenue and/or corporate tax revenue continues to comprise a meaningful portion of the program. As of December 31, 2006, 56 of SERS' active managers held investments impacting the state. SERS' market values of Pennsylvania-based and non-PA based companies impacting the Commonwealth are \$190 million and \$408 million,

# Pennsylvania Investments Summary *(continued)*

respectively. This equates to 14.1% of the alternative investment program market value.

As of December 31, 2006, SERS' venture capital and private equity partnerships invested in 123 Pennsylvania companies employing approximately 18,150 employees, and representing a payroll of \$980 million. In addition, partnerships in which SERS participates invested in 93 companies domiciled outside Pennsylvania but employing 18,800 Pennsylvania citizens with payrolls of \$454 million. Based on a 3.07% income tax rate, this employment rate is expected to generate approximately \$44 million in state income tax revenue.

The number of employees and payroll reported from period to period is often volatile. This is due to several reasons, one of which is the nature of the investments. Venture capital investments often begin with a handful of employees and grow the staff as the companies progress, while investments in companies facing some type of impediment often involve cost cutting measures. These reported numbers change dramatically as companies are added or deleted from the portfolio. Other reasons for the changes in the numbers include inconsistent reporting or lack of reporting by the portfolio companies to the general partners. Additionally, the report does not differentiate between permanent full time positions created and seasonal or part-time positions. Therefore, there may be a significant increase in the number of Pennsylvanians employed with a minimal increase in the total payroll if a company such as Blockbuster, which primarily employs minimum wage, part-time employees, is held in the portfolio. This highlights a few of the causes for the volatile nature of the numbers, but is by no means all inclusive. There are many others factors to be considered. In any event it is clear Venture Capital investments create jobs in Pennsylvania: a 2004 study by the National Venture Capital Association ranked the top five states by employment at venture capital backed firms headquartered in state as of 2003. Pennsylvania ranked 4<sup>th</sup> with 604,000 employees at venture backed firms. California ranked 1<sup>st</sup>, Texas 2<sup>nd</sup>, and Massachusetts 3<sup>rd</sup>.

Although the Board's fiduciary duty is to SERS' members and beneficiaries, investments in Pennsylvania provide an ancillary and subordinate benefit to the state's economy as indicated above. The investment policy acknowledges that such benefit, e.g., derived from investments in Pennsylvania-based companies, or firms employing Pennsylvanians, should be considered after other primary fiduciary investment characteristics are satisfied.

The following companies are examples of Pennsylvania investments funded by SERS' private equity and venture capital partnerships:

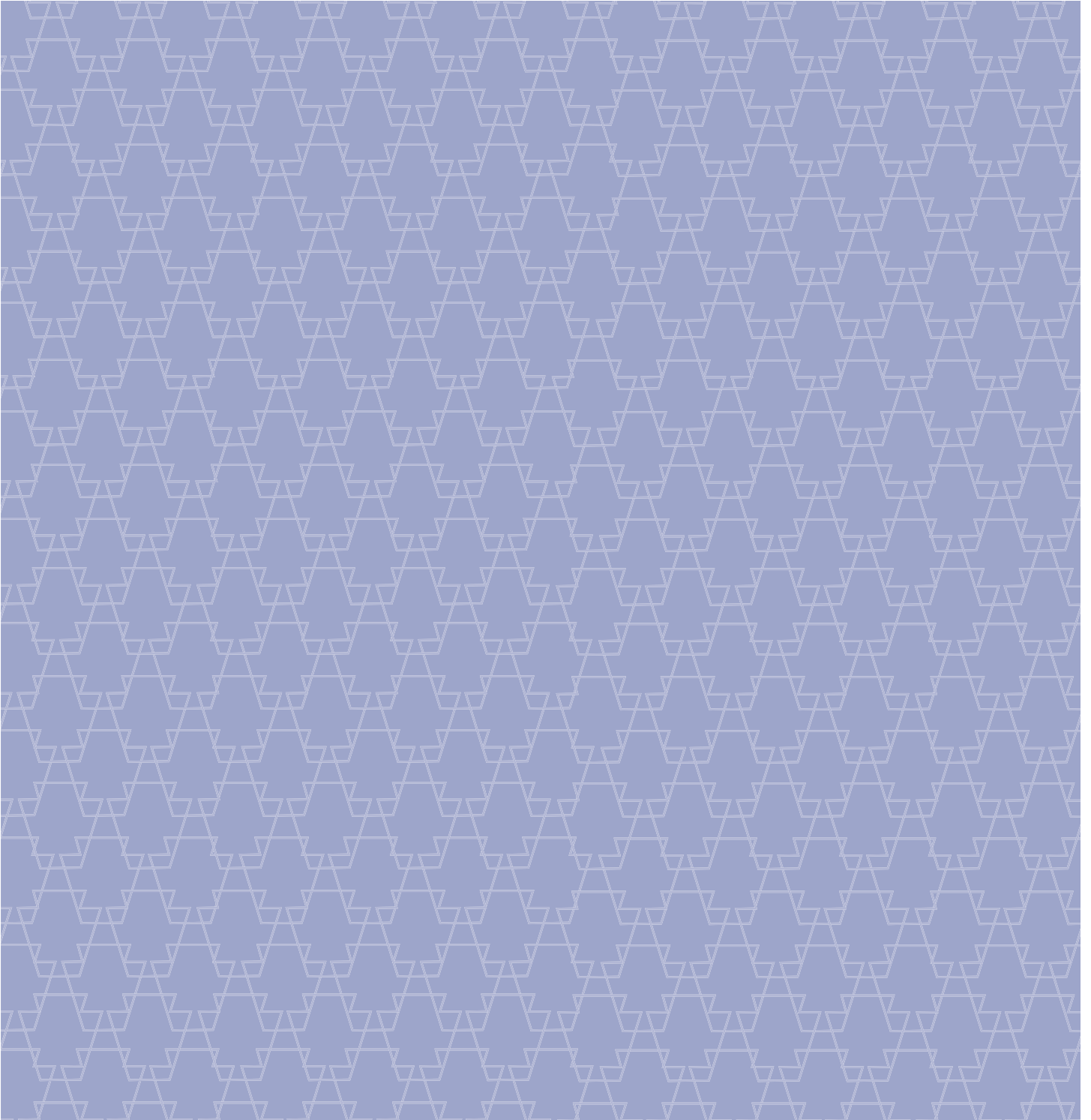
- **Brightside Academy** (Mid-Atlantic Ventures III) Brightside Academy provides early care and education for children in a safe, nurturing environment. They provide support to families through the development of a strong partnership, sense of community and mutual respect. Brightside currently serves 4,800 children in 38 locations, 36 of them located in Pennsylvania. The company has 874 employees with a total PA payroll of \$18.8 million.
- **Education Management Corp., Inc.** (Leeds Equity Partners IV, Providence Equity Partners V) One of the largest providers of private post-secondary education in North America, based on student enrollment and revenue, with over 72,000 students as of fall 2005 at 72 primary campus locations in 24 states and two Canadian provinces. It offers a broad range of academic programs in the media arts, design, fashion, culinary arts, behavioral sciences, health sciences, education, information technology and business, culminating in the award of associate's through doctoral degrees. This company employs 2,725 Pennsylvanians with a total PA payroll of \$144 million.
- **Graham Packaging** (Blackstone Capital Partners III) A worldwide leader in the design, manufacture, and sale of customized blow molded plastic containers for the branded food and beverage, household and personal care, and automotive lubricants markets with 56 plants throughout North America, Europe, and Latin America.
- **Nexstar Broadcasting Group, Inc.** (ABRY III) Nexstar is a television broadcasting company that focuses on the acquisition, development, and operation of television stations in medium-sized U.S. markets. Nexstar employs 230 Pennsylvania residents at an annual payroll of \$8.3 million.

# Pennsylvania Investments Summary *(continued)*

- **Sungard Data Systems** (Providence Equity V, Blackstone Capital Partners IV, Blackstone Communications I, TPG Partners III and TPG Partners IV) Sungard's main corporate office is located in Wayne, Pennsylvania. SunGard provides software and processing solutions for financial services, higher education and the public sector. The company also helps information-dependent enterprises of all types to ensure the continuity of their business. On a global basis, SunGard serves more than 25,000 customers in more than 50 countries. Sungard employs 3,000 Pennsylvania residents earning total annual salaries of \$160 million.
- **TargetRx** (Quaker BioVentures, NEA 9) TargetRx offers member physicians an online forum to share their attitudes and beliefs with pharmaceutical companies through surveys and other market research activities. Physicians gauge the effectiveness of existing therapies and identify the need for new treatments. TargetRx is based in Horsham. The company currently employs 99 PA residents. The total annual PA payroll approximates \$8 million.
- **TMG Health, Inc.** (SCP Private Equity Partners II) TMG offers business process outsourcing services to the Medicare, Medicaid, and retiree health plan markets. TMG provides operational outsourcing solutions and information systems for health plans, providers and insurers. The company is headquartered in King of Prussia with its national operation center located in Scranton. TMG currently employs approximately 895 PA citizens with a payroll of \$24.5 million.
- **VWR** (Clayton, Dublier & Rice VI) VWR International, formerly a Merck KGaA subsidiary, distributes more than 1.2 million different laboratory products. These goods range from chemicals to lab instruments to protective clothing; suppliers include Applied Scientific, Carl Zeiss, Duracell, Kimberly Clark, and Welch Allyn. The goods are sold to more than 250,000 customers in Europe and North America. Other services include training, technical support, and supply chain systems integration. The company employs 290 Pennsylvanians with total PA payroll of \$28 million.



# Women/Minority Advisors and Brokers



# Women/Minority Investment Advisor and Broker Report

December 31, 2006

## Investment Advisors

The following five women or minority-owned firms were under contract with SERS to provide investment advisory services as of December 31, 2006.

<b>Firm</b>	<b>Status</b>	<b>SERS Assets Under Management</b>
Fairview Capital I & II	Minority Woman-Owned	\$20.0 million commitment (19.6 million actually funded)
MDL Capital Management	Minority-Owned	95.8 million (market value)
Pacific Alternative Asset Management Co.	Woman-Owned	1,875.2 million (market value)
Rock Creek	Woman/Minority-Owned	669.2 million (market value)
Taplin, Canada	Minority Woman-Owned	105.4 million (market value)

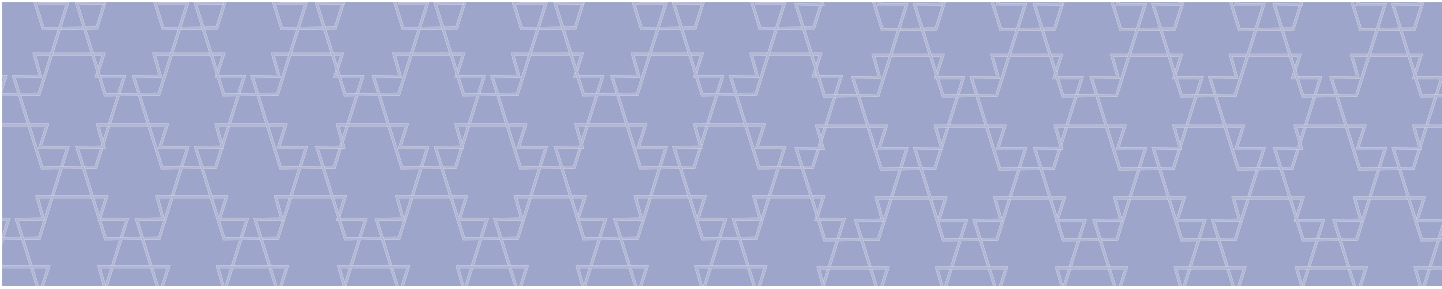
## Brokers and Brokerage Commissions

SERS's external investment advisors utilized the following minority-owned brokerage firms during calendar year 2006.

<b>Firm</b>	<b>SERS Commissions</b>	<b>Firm</b>	<b>SERS Commissions</b>
Berean Capital	\$3,104	Melvin	\$2,290
BOE Securities	1,375	Mischler Financial Group	42,337
Cabrera	9,114	Mogavero Lee & Co	5,802
East West Securities	141,442	Montrose Securities	3,977
Great Pacific	686	Multitrade (B-Berg)	24,320
Guzman & Company	11,489	Pacific American	8,732
Institutional Capital	73,512	PCS Securities	11,362
Ivy Securities	25,570	Saratoga	15,710
J.K.V. Global Enterprises	9,512	Screaming Eagle Trading	40,919
Jackson Partners	980	Selsia Securities	31,927
Loop Capital	4,306	Sturdivant & Co.	104,175
Magna Capital	7,594	Williams Capital Group	25,779
<b>Total Minority Commissions</b>		<b>\$606,014</b>	

Minority commissions totaled \$606,014 for the year. Of this amount, international stock managers had \$202,446 of commissions credited to minority brokers. The SERS Board has a policy of targeting 5%–10% of domestic stock commissions to be done with minority brokers. Domestic stock managers directed 14.3% of commissions through minority brokers. In addition, although not included in the Board mandate, other SERS advisors are encouraged to trade through minority brokers. Fixed income managers traded \$81.1 million of securities through minority brokers.





# Deferred Compensation Program



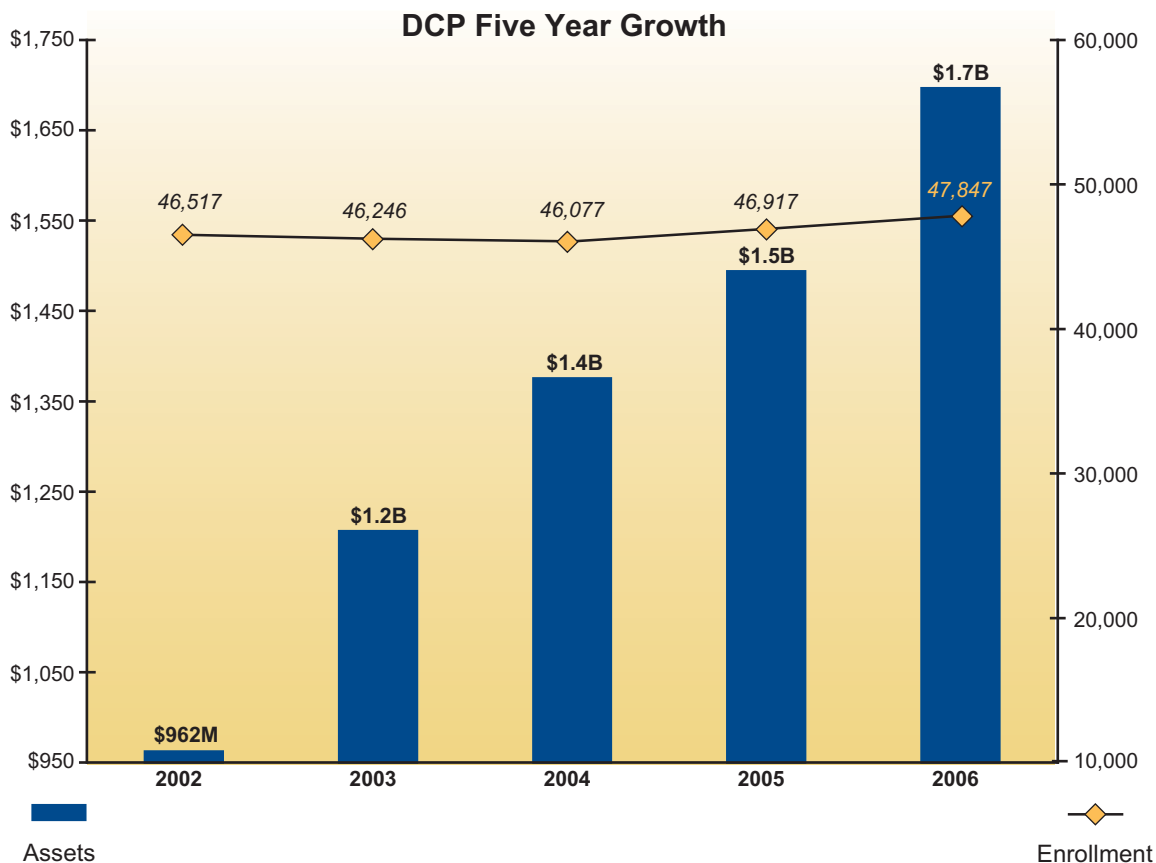
# Deferred Compensation Program

## Program History

Act 1987-81 assigned to the SERS Board (SERB) the responsibility to establish and monitor a Deferred Compensation Program for Commonwealth officers and employees, through which participants may voluntarily build retirement savings by deferring a portion of salary to selected investment options. The Program is established as a trust, and is administered in accordance with Internal Revenue Code Section 457(b). Through the Request for Proposal process, the SERB selected Great-West Retirement Services as Third Party Administrator (TPA) of the Deferred Compensation Program. The duties of the TPA are to maintain individual participant records, market the program to participants, and counsel the members about the Program's benefits. The core investment options are selected by the SERB, and are independent of the TPA's functions.

## Growth of the Program

Over the past five years, the Program's assets have significantly increased in value from \$962 million to approximately \$1.7 billion. As of December 31, 2006, there were 47,847 active and inactive participants in the Program. Over 46% of all eligible employees participate in the Program. The amount of annual participant deferrals remained steady over the past five years ranging from \$122 million in 2002, to \$126 million in 2006. Benefit payments to participants increased over that same time span, from \$31 million in 2002, to \$41 million in 2006. The chart below depicts the Program's asset and participation levels over the past five years.



# Deferred Compensation Program *(continued)*

## Program Highlights

The Program provides participant assistance via individual and/or group counseling sessions with the eligible employee, at the employees' work site. The TPA has established a local walk-in office in the Harrisburg downtown area. A toll free telephone service with counselors is also available to offer personal assistance. A telephone Voice Response Unit can be accessed at anytime to allow the participant to check on their account balances, transfer funds among different investment options or inquire about other Program features. The participants may also access the Program's Web site to view their most recent investment position, to make future allocation changes, to transfer among investment options and to update beneficiary information.

