

**ILLINOIS STATE BOARD OF INVESTMENT**  
An Internal Investment Pool of the State of Illinois

Financial Statements  
June 30, 2014  
(With Independent Auditors' Report Thereon)  
Performed as Special Assistant Auditors  
for the Auditor General, State of Illinois



Assurance ■ Tax ■ Consulting

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**ILLINOIS STATE BOARD OF INVESTMENT**  
An Internal Investment Pool of the State of Illinois

**Financial Statement Report**

**Summary**

The audits of the accompanying financial statements of the Illinois State Board of Investment (ISBI) were performed by McGladrey LLP as of and for the years ended June 30, 2014 and 2013.

Based on their audits, the auditors expressed an unmodified opinion on the ISBI's basic financial statements.



## Independent Auditors' Report

Honorable William G. Holland  
Auditor General  
State of Illinois

Board of Trustees  
Illinois State Board of Investment

### Report on the Financial Statements

As Special Assistant Auditors for the Auditor General, we have audited the accompanying Statements of Net Position of the Illinois State Board of Investment Member Systems (ISBI Member Systems), an internal investment pool of the State of Illinois, as of and for the years ended June 30, 2014 and 2013, and the accompanying Statements of Net Position of its investment trust fund, the Illinois Power Agency Trust Fund (Trust Fund) as of June 30, 2014 and June 30, 2013, and the related Statements of Changes in Net Position and the related notes to the financial statements for the years then ended, which collectively comprise the Illinois State Board of Investment's (ISBI) basic financial statements as listed in the table of contents.

### *Management's Responsibility for the Financial Statements*

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditors' Responsibility*

Our responsibility is to express opinions on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

## **Opinions**

In our opinion, the financial statements referred to above present fairly, in all material respects, the net position of ISBI Member Systems, as of June 30, 2014 and 2013, and the changes in net position for the years then ended, and its investment trust fund, the Illinois Power Agency Trust Fund, as of June 30, 2014 and 2013, in accordance with accounting principles generally accepted in the United States of America.

## **Other Matters**

### *Required Supplementary Information*

Accounting principles generally accepted in the United States of America require that the management's discussion and analysis on pages 4-6 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

### **Other Reporting Required by Government Auditing Standards**

In accordance with *Government Auditing Standards*, we have also issued our report dated December 2, 2014 on our consideration of the ISBI Member Systems and Trust Fund's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering the ISBI Member Systems and Trust Fund's internal control over financial reporting and compliance.

*McGladrey LLP*

Schaumburg, Illinois  
December 2, 2014

## **Illinois State Board of Investment**

### **Management's Discussion and Analysis**

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In October 1969, the Illinois State Board of Investment (ISBI) was created by enactment of Article 22A of the Illinois Pension Code by the 76<sup>th</sup> General Assembly of Illinois. By statute, ISBI was given the responsibility for management of the assets of the General Assembly Retirement System, the Judges' Retirement System of Illinois and the State Employees' Retirement System of Illinois (Member Systems). Also, in August 2007, by enactment of 30 ILCS 105/6z-75 of the Illinois Compiled Statutes, ISBI was given responsibility for the management of the Illinois Power Agency Trust Fund. Board membership consists of five members appointed by the Governor and four ex officio members consisting of the State Treasurer and the Chairman of the Board of Trustees of each of the retirement systems. ISBI maintains its office in Chicago, Illinois.

The following Management's Discussion and Analysis (MD&A) provides an introduction and overview of the Illinois State Board of Investment (ISBI) financial activities for the fiscal years ended June 30, 2014 and 2013.

#### **Financial Highlights**

The net position of ISBI totaled approximately \$15.1 billion at fiscal year end June 30, 2014, compared to approximately \$12.9 billion at June 30, 2013. The increase from the previous year is primarily the result of investment gains.

#### **General Market Risk**

ISBI is exposed to general market risk. This general market risk is reflected in asset valuations fluctuating with market volatility. Any impact from market volatility on ISBI's investment portfolio depends in large measure on how deep the market downturn is, how long it lasts, and how it fits within fiscal year reporting periods. The resulting market risk and associated realized and unrealized gains and losses could significantly impact ISBI's financial condition. The readers of these financial statements are advised that financial markets continue to be volatile and are experiencing significant changes on almost a daily basis.

#### **Overview of the Financial Statements**

ISBI's financial statements are prepared on an accrual basis in accordance with U.S. generally accepted accounting principles promulgated by the Governmental Accounting Standards Board and are comprised of the Statements of Net Position, the Statements of Changes in Net Position and Notes to Financial Statements.

The Statements of Net Position presents information on ISBI's assets and liabilities and the resulting net position. This statement also reflects ISBI's investments along with the cash and short-term investments, receivables, and other assets and liabilities.

The gain in investments at June 30, 2014 is a result of an investment gain of 17.9% for the fiscal year, net of expenses which are shown in the Statements of Changes in Net Position. The slight decrease in liabilities for fiscal 2014 compared with 2013 is consistent with a large amount of investment purchases at year-end to rebalance the portfolio. The increase in liabilities for fiscal 2013 compared with 2012 consisted mainly of an increase in payables for investment purchases. This increase in investment payables was a result of the rebalancing of the portfolio and updates to the asset allocation due to approval of Marquette Associates to be retained as a result of an RFP for General and/or Real Estate Investment Consulting services. As consistent with the Investment Policy of ISBI, the conclusion of that process automatically triggers a new asset allocation study. Marquette Associates put forth Asset Allocation recommendations that were approved at the ISBI June 2013 Board meeting.

For the year ended June 30, 2014, the annual money-weighted rate of return on pension plan investments, net of pension plan investment expense, was 17.86 percent. The money-weighted rate of return expresses investment performance, net of investment expense, adjusted for the changing amounts actually invested.

## Illinois State Board of Investment

### Management's Discussion and Analysis (Continued)

The Statements of Changes in Net Position present information regarding changes during the fiscal year ended June 30, 2014. These statements reflect additions and deductions, which include the investment income and losses derived from realized and unrealized gains/losses, member system contributions, and income received from securities lending activities. Also reflected in the statements are deductions, which include withdrawals from the Member Systems and operating expenses of ISBI.

	Condensed Summary of Net Position			2014/2013 Change	2013/2012 Change
	2014	2013	2012		
	\$	\$	\$	\$	\$
Cash	9,397,247	21,388,387	45,594,194	(11,991,140)	(24,205,807)
Receivables	401,298,113	418,929,069	88,691,020	(17,630,956)	330,238,049
Investments	15,116,104,672	12,849,984,270	11,257,803,766	2,266,120,402	1,592,180,504
Securities lending collateral	60,129,299	59,175,835	67,901,315	953,464	(8,725,480)
Prepaid expenses	14,565	27,946	20,900	(13,381)	7,046
Capital assets	42,514	44,076	37,599	(1,562)	6,477
Total assets	15,586,986,410	13,349,549,583	11,460,048,794	2,237,436,827	1,889,500,789
Liabilities	477,611,035	483,092,347	176,112,109	(5,481,312)	306,980,238
Total net position	15,109,375,375	12,866,457,236	11,283,936,685	2,242,918,139	1,582,520,551

The net investment gains for the year ended June 30, 2014 were the result of upward movement in the securities markets. There was an increase in withdrawals by the member systems. Fiscal year 2014 withdrawals were \$65.1 million compared with \$29.8 million in fiscal year 2013. Withdrawals are determined by the member retirement systems based on the State of Illinois' funding and the Member Systems' benefit payment needs. As a result of a one-time transfer to the State Employees' Retirement System to pay for the FY2013 overpayment per ILCS 5/14-131(f) withdrawals increased for the year. The increase in administrative expenses for fiscal year 2014 compared to 2013 is due to an upward movement in the value of the portfolio which is the base for calculation of investment management fees.

The net investment gains for the year ended June 30, 2013 were the result of an upward movement in the securities markets. There was a decrease in withdrawals by the Member Systems. Fiscal year 2013 withdrawals were \$29.8 million compared with \$248.7 million in fiscal year 2012. Withdrawals are determined by the member retirement systems based on the State of Illinois' funding and the Member Systems' benefit payment needs. As a result of employer and employee funding transfers being sent directly by the State to the Member Systems, rather than to ISBI, withdrawals decreased for the year. The increase in administrative expenses for fiscal year 2013 compared to 2012 is due to an upward movement in the value of the portfolio which is the base for calculation of investment manager fees.

## Illinois State Board of Investment

### Management's Discussion and Analysis (Continued)

#### Condensed Statement of Changes in Net Position

	Fiscal Years Ended June 30			2014/2013	2013/2012
	2014	2013	2012	Change	Change
	\$	\$	\$	\$	\$
<b>Additions:</b>					
Net investment income	2,334,760,880	1,625,321,501	41,440,456	709,439,379	1,583,881,045
Contributions from the State of Illinois	16,000,000	24,900,254	-	(8,900,254)	24,900,254
<b>Total additions</b>	<b>2,350,760,880</b>	<b>1,650,221,755</b>	<b>41,440,456</b>	<b>700,539,125</b>	<b>1,608,781,299</b>
<b>Deductions:</b>					
Member systems' withdrawals	65,062,913	29,792,192	248,725,000	35,270,721	(218,932,808)
Administrative expenses	42,779,828	37,909,012	36,403,795	4,870,816	1,505,217
<b>Total deductions</b>	<b>107,842,741</b>	<b>67,701,204</b>	<b>285,128,795</b>	<b>40,141,537</b>	<b>(217,427,591)</b>
<b>Net increase (decrease) in net position</b>	<b>2,242,918,139</b>	<b>1,582,520,551</b>	<b>(243,688,339)</b>	<b>660,397,588</b>	<b>1,826,208,890</b>

### Future Outlook

The Notes to Financial Statements provide additional information, which is necessary to fully understand the data provided in the financial statements.

At the April 8, 2014 meeting of the Board of Trustees of the State Employees' Retirement System (SERS), as a part of a periodic review of all actuarial assumptions, the Board voted unanimously to reduce the SERS annual investment return assumption from 7.75% to 7.25%. The Judges' Retirement System and the General Assembly Retirement System investment return assumption remains unchanged at 7.0%. This change is effective July 1, 2014.



Illinois State Board of Investment

Statements of Net Position  
June 30, 2014 and 2013

	Illinois State Board of Investment Member Systems		Illinois Power Agency Trust Fund		Total Illinois State Board of Investment	
	2014	2013	2014	2013	2014	2013
	\$	\$	\$	\$	\$	\$
<b>ASSETS</b>						
Cash	9,376,958	21,341,438	20,289	46,949	9,397,247	21,388,387
Receivables:						
Foreign taxes	2,735,624	3,818,718	5,919	8,401	2,741,543	3,827,119
Accounts receivable	1,519,374	-	3,288	-	1,522,662	-
Investments sold	356,879,941	378,290,890	772,192	832,199	357,652,133	379,123,089
Interest and dividends	39,296,747	35,899,885	85,028	78,976	39,381,775	35,978,861
Total receivables	400,431,686	418,009,493	866,427	919,576	401,298,113	418,929,069
Prepaid expenses	14,534	27,885	31	61	14,565	27,946
Capital assets	42,422	43,979	92	97	42,514	44,076
Investments at fair value:						
Government and agency obligations	782,781,918	885,452,173	1,693,730	1,947,900	784,475,648	887,400,073
Foreign obligations	830,485,454	414,158,908	1,796,948	911,105	832,282,402	415,070,013
Corporate obligations	797,788,043	672,674,316	1,726,199	1,479,812	799,514,242	674,154,128
Common stock and equity funds	4,543,452,501	3,907,881,384	9,830,815	8,596,921	4,553,283,316	3,916,478,305
Commingled funds	731,428,365	316,711,664	1,582,615	696,732	733,010,980	317,408,396
Foreign equity securities	2,341,436,888	2,324,274,475	5,066,241	5,113,155	2,346,503,129	2,329,387,630
Foreign preferred stock	72,750	480,436	157	1,057	72,907	481,493
Hedge funds	1,481,938,543	1,164,041,715	3,206,517	2,560,767	1,485,145,060	1,166,602,482
Real estate funds	1,480,243,122	1,291,759,244	3,202,849	2,841,732	1,483,445,971	1,294,600,976
Private equity	666,288,596	642,362,400	1,441,670	1,413,129	667,730,266	643,775,529
Money market instruments	217,266,893	237,128,125	470,107	521,656	217,737,000	237,649,781
Real assets	523,152,831	549,530,135	1,131,962	1,208,907	524,284,793	550,739,042
Bank loans	687,768,412	415,734,675	1,488,146	914,572	689,256,558	416,649,247
Foreign currency forward contracts	(636,223)	(411,919)	(1,377)	(906)	(637,600)	(412,825)
Total investments	15,083,468,093	12,821,777,731	32,636,579	28,206,539	15,116,104,672	12,849,984,270
Securities lending collateral	59,999,476	59,045,940	129,823	129,895	60,129,299	59,175,835
<b>Total assets</b>	<b>15,553,333,169</b>	<b>13,320,246,466</b>	<b>33,653,241</b>	<b>29,303,117</b>	<b>15,586,986,410</b>	<b>13,349,549,583</b>
<b>LIABILITIES</b>						
Payables:						
Investments purchased	406,924,166	412,911,779	880,475	908,362	407,804,641	413,820,141
Administrative expenses	8,378,940	7,051,522	18,130	15,513	8,397,070	7,067,035
Securities lending cash collateral obligation	61,276,738	61,395,778	132,586	135,064	61,409,324	61,530,842
Other liabilities	-	672,849	-	1,480	-	674,329
<b>Total liabilities</b>	<b>476,579,844</b>	<b>482,031,928</b>	<b>1,031,191</b>	<b>1,060,419</b>	<b>477,611,035</b>	<b>483,092,347</b>
<b>Net position</b>	<b>15,076,753,325</b>	<b>12,838,214,538</b>	<b>32,622,050</b>	<b>28,242,698</b>	<b>15,109,375,375</b>	<b>12,866,457,236</b>

See notes to financial statements, pages 9 - 25.

Illinois State Board of Investment

Statements of Changes in Net Position  
June 30, 2014 and 2013

	Illinois State Board of Investment Member Systems		Illinois Power Agency Trust Fund		Total Illinois State Board of Investment	
	2014	2013	2014	2013	2014	2013
	\$	\$	\$	\$	\$	\$
<b>ADDITIONS</b>						
Investment income:						
Net increase in fair value of investments	1,908,636,433	1,250,868,283	4,202,702	2,700,515	1,912,839,135	1,253,568,798
Interest and other	263,808,067	216,178,681	580,167	476,442	264,388,234	216,655,123
Dividends	153,952,707	150,016,364	338,572	330,625	154,291,279	150,346,989
Securities lending income	182,900	293,085	402	646	183,302	293,731
Securities lending rebates	3,392,284	4,944,647	7,437	10,894	3,399,721	4,955,541
Securities lending expense	(340,045)	(497,585)	(746)	(1,096)	(340,791)	(498,681)
Total investment income	2,329,632,346	1,621,803,475	5,128,534	3,518,026	2,334,760,880	1,625,321,501
Contributions from the State of Illinois	16,000,000	-	-	24,900,254	16,000,000	24,900,254
Total additions	2,345,632,346	1,621,803,475	5,128,534	28,418,280	2,350,760,880	1,650,221,755
<b>DEDUCTIONS</b>						
Administrative expenses:						
Salaries and benefits:						
Salaries	1,144,901	1,154,988	2,516	2,546	1,147,417	1,157,534
Benefits	748,626	812,850	1,646	1,792	750,272	814,642
Operating expenses:						
Rent and utilities	187,702	177,968	413	392	188,115	178,360
Audit	176,542	168,668	388	372	176,930	169,040
Other	239,586	191,535	527	422	240,113	191,957
External support:						
Custody	219,517	219,516	483	484	220,000	220,000
Consulting and professional	1,209,191	1,059,070	2,659	2,335	1,211,850	1,061,405
Investment advisors/managers	38,474,339	33,797,654	84,589	74,510	38,558,928	33,872,164
Investment services and research	285,575	243,373	628	537	286,203	243,910
Total administrative expenses	42,685,979	37,825,622	93,849	83,390	42,779,828	37,909,012
Member Systems' withdrawals	64,407,580	29,700,000	655,333	92,192	65,062,913	29,792,192
Total deductions	107,093,559	67,525,622	749,182	175,582	107,842,741	67,701,204
Increase in net position	2,238,538,787	1,554,277,853	4,379,352	28,242,698	2,242,918,139	1,582,520,551
Net position at beginning of year	12,838,214,538	11,283,936,685	28,242,698	-	12,866,457,236	11,283,936,685
Net position at end of year	15,076,753,325	12,838,214,538	32,622,050	28,242,698	15,109,375,375	12,866,457,236

See notes to financial statements, pages 9 - 25.

## Illinois State Board of Investment

### Notes to Financial Statements

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#### Note 1. Summary of Significant Accounting Policies

##### Reporting Entity

The Illinois State Board of Investment (ISBI) is considered to be an internal investment pool of the State of Illinois, operating from investment income and contributions from the State of Illinois. ISBI manages and invests the pension assets of three separate public employee retirement systems (Member Systems): General Assembly Retirement System, the Judges' Retirement System of Illinois, and State Employees' Retirement System of Illinois. ISBI also manages the assets of the Illinois Power Agency Trust Fund (Trust Fund). The Trust Fund is reported as an investment trust fund of ISBI.

The assets of the Member Systems and the Trust Fund are accounted for in a single commingled fund. Separate information on each System's participation is presented in Note 3. The assets of the Trust Fund came under management of ISBI in fiscal year 2012. The assets and liabilities of the Trust Fund are reported on the Statements of Net Position. The revenues and expenses for the Trust Fund for fiscal years 2014 and 2013 are reported on the Statements of Changes in Net Position.

##### Basis of Accounting

Accounting records are maintained on an accrual basis. Units are allocated monthly to each Member System and the Illinois Power Agency Trust Fund based upon percentage of ownership. Administrative expenses are deducted monthly from income before allocation.

##### Valuation of Investments

Investments owned are reported at fair value as follows: (1) U.S. Government and Agency, Foreign and Corporate Obligations, Convertible Bonds – prices quoted by a major dealer in such securities; (2) Common Stock and Equity Funds, Foreign Preferred Stock, Foreign Equity Securities, Forward Foreign Currency Contracts and Options: (a) Listed – closing prices as reported on the composite summary of national securities exchanges; (b) Over-the-counter – bid prices; (3) Money Market Instruments – average cost which approximates fair values; (4) Real Estate Investments – fair values as determined by ISBI and its investment managers; (5) Alternative Investments (Private Equity, Hedge funds, Bank Loans and Real Assets) – fair values as determined by ISBI and its investment managers; (6) Commingled funds – fair values as determined by ISBI and its investment managers.

##### Investment Transactions and Investment Income

Investment transactions are accounted for on a trade date (date order to buy or sell is initiated) and dividend income is recognized on the ex-dividend date. Interest income is recognized on an accrual basis.

##### Custody and Investment Management Fees

ISBI has contracted with investment managers approved by the Board of Trustees to make investment decisions based on investment guidelines provided to them by ISBI staff and consultants. The investment managers serve as investment advisors to ISBI. ISBI pays an investment management fee to each investment manager for these services on a quarterly basis. The investment management fee is based upon contractual agreement provisions and is computed as a percentage of each manager's portfolio market value.

Management fees paid to Real Estate funds and Private Equity funds are calculated based upon the terms of each individual fund agreement and are reported in Investment Income on the Statements of Changes in Net Position. Management fees paid to Hedge funds, certain Real Assets, Commingled funds and Bank Loan funds are calculated based on each manager's portfolio market value or ISBI's capital commitment and are reported as Investment Advisor/Managers Expense on the Statements of Changes in Net Position. Certain other infrastructure fund fees are reported net of investment income on the Statements of Changes in Net Position.

## Illinois State Board of Investment

### Notes to Financial Statements

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#### **Note 1. Summary of Significant Accounting Policies (Continued)**

ISBI has contracted with State Street Bank and Trust Company (State Street) to provide custody services for the pension systems assets. These services include safekeeping and transaction processing services for all pension assets of the Member Systems. State Street also provides cash management services and all necessary reporting for pension assets including performance reporting and accounting reports. There are no base charges for custody fees. Custody fees paid to State Street are paid based on set quarterly amounts per the Custodian Contract for performance and analytics services and various accounting data interface feeds.

#### **Risk Management**

ISBI, as part of the State, provides for risks of loss associated with workers' compensation and general liability through the State's self-insurance program, which handles processing of all claims. ISBI obtains commercial insurance for fidelity and surety and property. There have been no commercial insurance claims in the past five years.

#### **Risks and Uncertainties**

ISBI invests in various investment securities. Investment securities are exposed to various risks such as interest rate, market, and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the Statements of Net Position.

#### **Use of Estimates**

In preparing financial statements in conformity with U.S. generally accepted accounting principles, ISBI makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements, as well as the reported amounts of additions and deductions during the reporting period. Actual results could differ from those estimates and assumptions and the differences may be material.

The determination of fair value for illiquid/alternative investments, such as investments in Real Estate and Private Equity funds, takes into account consideration of a range of factors, including but not limited to the price at which the underlying investments were acquired, the nature of the underlying investments, local market conditions, trading values on public exchanges for comparable underlying investments, current and projected operating performance of the underlying investments, and financing transactions subsequent to the acquisition of the investment. Determining fair value of such investments involves a significant degree of judgment by ISBI and its investment managers.

Because of the inherent uncertainty of the above referenced fair values, the estimated values may differ significantly from the values that would have been used had a ready market for the securities existed, and the differences could be material.

#### **Compensated Absences**

The liability for compensated absences consists of unpaid, accumulated vacation and sick leave balances for ISBI employees. The liability has been calculated using the vesting method, in which leave amounts for both employees who are currently eligible to receive termination payments, and other employees who are expected to become eligible in the future to receive such payments upon termination are included. The liability has been calculated based on the employees' current salary and includes salary related costs (e.g., social security and Medicare tax). The liability is included in Administrative Expenses on the Statements of Net Position and the annual increase or decrease in the liability is reflected in the Salaries Expense on the Statements of Changes in Net Position.

## Illinois State Board of Investment

### Notes to Financial Statements

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#### **Note 1. Summary of Significant Accounting Policies (Continued)**

Legislation that became effective January 1, 1998 capped the paid sick leave for all State Employees' Retirement System members at December 31, 1997. Employees continue to accrue twelve sick days per year, but will not receive monetary compensation for any additional time earned after December 31, 1997. Sick days earned between 1984 and December 31, 1997 (with a 50% cash value) would only be used after all days with no cash value are depleted. Any sick days earned and unused after December 31, 1997 will be converted to service time for purposes of calculating employee pension benefits.

#### **Subsequent Events**

ISBI has evaluated subsequent events for potential recognition and/or disclosure through December 2, 2014, the date the financial statements were available to be issued.

#### **Note 2. Deposits, Investments, and Investment Risk**

##### **Deposits**

Custodial credit risk for deposits is the risk that, in the event of a financial institution failure, ISBI's deposits may not be returned. All non-investment related bank balances at year-end are insured or collateralized with securities held by the Illinois State Treasurer or agents in the name of the State Treasurer. As of June 30, 2014 and 2013, ISBI had non-investment related bank balances of \$474,083 and \$449,417, respectively. During fiscal year 2007, a Credit Risk Policy was implemented by ISBI staff and formally adopted by ISBI in July of 2007. The Policy outlines the control procedures used to monitor custodial credit risk. These assets are under the custody of State Street Bank and Trust Company. State Street Bank and Trust Company has an AA- Long-term Deposit/Debt rating by Standard & Poors and an Aa3 rating by Moody. Certain investments of ISBI with maturities of 90 days or less would be considered cash equivalents; these consist of short-term investment funds and U.S. Treasury bills with maturities of 90 days or less, which are not subject to the custodial credit risk. For financial statement presentation and investment purposes, ISBI reports these types of cash equivalents as Money Market Instruments in the Statements of Net Position. As of June 30, 2014 and 2013, ISBI had investment related bank balances of \$8,923,164 and \$21,092,710, respectively. These balances include USD and foreign cash balances. As of January 1, 2013, cash held in the investment related bank account is neither insured nor collateralized for amounts in excess of \$250,000. At any given point and time the foreign cash balances may be exposed to custodial credit risk.

##### **Investment Policy**

ISBI's investment authority and responsibilities are specified in the Illinois Compiled Statutes, 40ILCS 5/22A. These statutes provide ISBI with the authority to manage and invest the assets of any Illinois pension or education fund.

As described in Note 1, ISBI currently manages and invests the assets of the General Assembly Retirement System, Judges' Retirement System, and State Employees' Retirement System and the Illinois Power Agency Trust Fund. All investments undertaken by ISBI are governed by 40ILCS 5 adopted by the General Assembly in 1982, and other standards codified in the above reference to the statutes.

## Illinois State Board of Investment

### Notes to Financial Statements

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#### **Note 2. Deposits, Investments, and Investment Risk (Continued)**

40ILCS 5/1-109 requires all members of the ISBI and other fiduciaries to "... discharge his or her duties with respect to the retirement system or pension fund solely in the interest of the participants and beneficiaries and: With the care, skill, prudence and diligence...By diversifying the investments of the retirement system or pension fund so as to minimize the risk of large losses..."

#### **Investment Commitments**

Real Estate and Private Equity investment portfolios consist of passive interests in limited partnerships. ISBI had outstanding commitments to these limited partnerships of approximately \$426 million and \$278 million as of June 30, 2014 and 2013, respectively. At the end of fiscal year 2014 and 2013, ISBI had outstanding commitments of \$61 million and \$7 million to separate real estate accounts, respectively. Also at the end of fiscal year 2014 and 2013, ISBI had outstanding amounts of \$32 million and \$60 million to real assets, respectively. ISBI would fund outstanding commitments by utilizing available cash and then selling liquid securities in the portfolio as necessary. ISBI had total investment commitments of \$519 million and \$345 million at the end of fiscal years 2014 and 2013, respectively.

#### **Investment Liquidity**

ISBI holds investments in hedge funds, real estate funds, private equity funds and real assets that are considered illiquid by the very nature of the investment. Market risk exists with respect to these investments as ISBI may not be able to exit from the investments during periods of significant market value declines.

#### **Rate of Return**

For the year ended June 30, 2014, the annual money-weighted rate of return on pension plan investments, net of pension plan investment expense, was 17.86 percent. The money-weighted rate of return expresses investment performance, net of investment expense, adjusted for the changing amounts actually invested. The money-weighted rate of return (MWRR) information is presented to assist the Member Systems to prospectively implement GASB 67 during fiscal year 2014; therefore, the 2013 MWRR information is not being presented as the information to perform the calculation was not available to ISBI.

#### **Alternative Investments**

Investments in hedge funds are structured to achieve a diversified hedged equity fund-of-funds portfolio. Capital is allocated to a select group of Hedge Fund managers that invest predominately in equity securities, both long and short. The investments shall be managed with the intent of preserving capital in a declining market and in a rising market they will generate a smaller return than the overall equity market. These investments are redeemable once the underlying assets are liquidated.

ISBI's investments in Private Equity and Real Estate funds represent investment vehicles used for making investments in various equity and debt securities according to the investment strategies as determined by the fund managers at the commencement of the fund.

Investment strategies of Private Equity funds include, but are not limited to, leveraged buyouts, venture capital, growth capital and mezzanine capital.

Investment strategies of Real Estate investments include, but are not limited to, the purchase, development, ownership, management, rental and/or sale of real estate for profit.

## Illinois State Board of Investment

### Notes to Financial Statements

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#### Note 2. Deposits, Investments, and Investment Risk (Continued)

Certain real estate investments are leveraged whereby partnerships have been established to purchase properties through a combination of contributions from ISBI and through acquisition of debt. At June 30, 2014, real estate equities of approximately \$1,483 million are reported at estimated fair value. Of this amount, \$1,288 million is equity and \$195 million is long-term debt. At June 30, 2013 real estate equities of approximately \$1,295 million were reported at estimated market value. Of this amount, \$1,145 million was equity and \$150 million was long term debt.

Required repayment of real estate debt, which is non-recourse debt, is as follows as of June 30, 2014 and 2013:

Debt Maturities Year Ending June 30	2014 \$	2013 \$
2014	-	-
2015	-	-
2016	28,240,488	28,591,489
2017	57,416,040	56,179,026
2018	-	-
2019-2023	88,046,051	43,165,198
2024-2026	21,321,503	22,382,920
	<u>195,024,082</u>	<u>150,318,633</u>

ISBI's investments in Real Assets represent pooled investment vehicles used to seek capital appreciation and current income by acquiring, holding, financing, refinancing and disposing of infrastructure investments and farmland assets. Real Assets include various public works (e.g. bridges, tunnels, toll roads, airports, public transportation and other public works) that are made typically as a part of a privatization initiative on the part of a government entity.

A Commingled fund is a kind of mutual fund or common trust fund which consists of multiple kinds of assets from several accounts combined together. 'Commingling' these separate assets mitigates risk for the trader through investment diversification and reduces the cost of managing each account separately. Commingled funds are also called "pooled funds" and "master trusts."

# Illinois State Board of Investment

## Notes to Financial Statements

### Note 2. Deposits, Investments, and Investment Risk (Continued)

#### Concentration of Credit Risk and Credit Risk for Investments

ISBI's portfolio of investments is managed by professional investment management firms. These investment management firms are required to maintain diversified portfolios. Each investment manager must comply with risk management guidelines individually assigned to them as part of their investment management agreement. ISBI did not have any single issuer investment that exceeded 5% of the total net assets of ISBI as of June 30, 2014 and 2013. The following table presents the quality ratings of debt securities held by ISBI as of June 30, 2014 and 2013:

	Moody's Quality Rating	2014 \$	2013 \$
U.S. Government obligations and agency obligations	AAA	425,527,082	874,539,113
	AA	7,344,587	5,090,968
	A	12,943,001	-
	Not rated	338,660,978	7,769,992
Total Government and agency obligations		<u>784,475,648</u>	<u>887,400,073</u>
Foreign obligations	AAA	141,563,493	76,120,555
	AA	186,950,502	97,449,851
	A	81,171,275	22,791,044
	BAA	204,409,825	39,580,632
	BA	36,645,027	14,681,590
	B	41,169,215	22,678,015
	CAA	-	849,000
	Not rated	140,373,065	140,919,326
Total foreign obligations		<u>832,282,402</u>	<u>415,070,013</u>
Corporate Obligations Bank and Finance	AA	2,957,585	2,299,452
	A	50,029,728	61,974,814
	BAA	82,453,817	59,330,835
	BA	34,830,061	22,522,230
	B	35,544,808	20,262,545
	Not rated	2,340,263	1,119
Total Bank and Finance		<u>208,156,262</u>	<u>166,390,995</u>
Collateralized Mortgage Obligations	AAA	-	912,944
Total Collateralized Mortgage Obligations		<u>-</u>	<u>912,944</u>
Industrial	AA	10,224,115	13,517,204
	A	21,987,306	35,977,341
	BAA	44,506,699	60,411,613
	BA	159,584,773	87,927,262
	B	209,039,592	188,374,139
	CAA	6,992,615	16,149,073
	Not rated	13,073,374	6,775,458
Total Industrial		<u>465,408,474</u>	<u>409,132,090</u>
Other	AAA	1,521,596	-
	A	7,995,874	21,306,286
	BAA	19,568,129	9,007,159
	BA	48,791,454	23,383,605
	B	48,352,453	41,440,430
	Not rated	(280,000)	2,580,619
Total Other		<u>125,949,506</u>	<u>97,718,099</u>
Total Corporate Obligations		<u>799,514,242</u>	<u>674,154,128</u>
Money Market	Not rated	217,737,000	237,649,781
Total Money Market		<u>217,737,000</u>	<u>237,649,781</u>



**Illinois State Board of Investment**

**Notes to Financial Statements**

**Note 2. Deposits, Investments, and Investment Risk (Continued)**

**Custodial Credit Risk for Investments**

The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, ISBI will not be able to recover the value of investments or collateral securities that are in the possession of a counterparty. As of June 30, 2014 and 2013, there were no investments that were uninsured and unregistered, securities held by the counterparty or by its trust department or agent but not in ISBI's name.

**Interest Rate Risk**

ISBI manages its exposure to fair value losses arising from interest rate risk by diversifying the debt securities portfolio and maintaining the debt securities portfolio to an effective weighted duration between 80% and 120% of the benchmark index.

Duration is the measure of a debt investment's exposure to fair value changes arising from changing interest rates. It uses the present value of cash flows, weighted for those cash flows as a percentage of the investment's fair value. The effective duration measures the sensitivity of market price to parallel shifts in the yield curve. As of June 30, 2014 and 2013, ISBI benchmarked its debt security portfolio to Barclay's Capital Intermediate U.S. Government/Credit Bond Index. At June 30, 2014 and 2013, the effective duration of the Barclay's Capital Intermediate U.S. Government/Credit Bond Index was 5.6 years and 5.5 years, respectively. At the same point in time, the effective duration of the ISBI debt security portfolio at June 30, 2014 and 2013 was 5.3 and 4.8 years, respectively. Below is the detail of the duration by investment type as of June 30, 2014 and 2013:

<u>Investment Type</u>	<u>2014</u>		<u>2013</u>	
	<u>Fair Value</u> \$	<u>Effective Weighted Duration</u> Years	<u>Fair Value</u> \$	<u>Effective Weighted Duration</u> Years
Government and Agency				
U.S. Government	380,521,606	6.7	381,380,855	5.8
Federal Agency	403,954,042	3.5	506,019,218	2.9
Foreign Obligations	832,282,402	5.8	415,070,013	5.8
Corporate Obligations				
Bank and Finance	208,156,262	5.8	166,390,995	5.4
Collateralized Mortgage	-	-	912,944	1.8
Industrial	465,408,474	4.7	409,132,090	4.8
Other	125,949,506	4.6	97,718,099	4.8
	<u>2,416,272,292</u>		<u>1,976,624,214</u>	

**Foreign Currency Risk**

The international portfolio is constructed on the principles of diversification, quality growth, and value. Risk of loss arises from changes in currency exchange rates. International managers may also engage in transactions to hedge currency at their discretion. Certain investments held in infrastructure funds trade in a reported currency of Euro-based dollars valued at \$61,343,167 and \$56,700,762 as of June 30, 2014 and 2013, respectively. The following table presents the foreign currency risk by type of investment as of June 30, 2014 and 2013:

Illinois State Board of Investment

Notes to Financial Statements

Note 2. Deposits, Investments, and Investment Risk (Continued)

	2014		2013	
	Foreign Equity Securities and Foreign Preferred Stock \$	Foreign Obligations \$	Foreign Equity Securities and Foreign Preferred Stock \$	Foreign Obligations \$
Australian Dollar	90,774,346	23,031,004	84,939,975	17,798,299
Brazilian Real	20,078,894	29,522,411	35,504,150	-
Canadian Dollar	141,782,577	36,442,872	128,661,034	22,047,815
Chilean Peso	-	3,713,553	1,319,421	2,742,742
Colombian Peso	-	15,223,691	-	-
Czech Koruna	804,780	3,560,005	422,126	2,955,792
Danish Krone	44,415,985	5,392,244	34,412,484	4,925,465
Egyptian Pound	627,634	-	1,067,693	-
English Pound Sterling	410,712,209	46,015,531	423,002,548	23,463,993
Euro Currency	614,324,960	144,113,041	531,593,533	124,284,551
Hong Kong Dollar	129,948,463	2,550,498	145,893,712	1,991,143
Hungarian Forint	642,189	329,052	1,691,945	-
Indonesian Rupiah	2,609,187	12,085,949	8,906,965	-
Israeli Shekel	2,886,339	4,040,894	2,992,079	45,464
Japanese Yen	302,710,537	66,876,957	273,783,526	65,746,192
Malaysian Ringgit	453,753	20,518,690	8,246,099	3,588,730
Mexican Peso	11,149,254	41,011,377	22,585,252	15,855,407
Moroccan Dirham	-	-	195,607	-
New Russian Ruble	-	41,669,459	-	-
New Zealand Dollar	3,297,560	2,365,325	3,914,051	2,392,523
Nigerian Naira	-	10,909,408	-	-
Norwegian Krone	30,066,361	5,799,023	27,605,678	7,137,733
Peruvian Nouveau Sol	-	1,817,219	-	-
Philippine Peso	-	755,069	2,511,702	-
Polish Zloty	-	25,311,976	3,126,169	6,352,962
Singapore Dollar	34,481,140	5,121,850	33,907,567	4,791,667
South African Rand	14,851,595	23,599,596	23,845,529	5,047,409
South Korean Won	72,778,832	21,003,245	84,875,633	18,591,249
Swedish Krona	41,872,359	2,241,325	32,302,268	9,448,272
Swiss Franc	219,282,841	12,141,173	218,884,679	8,538,778
Thailand Baht	-	8,619,111	4,935,467	5,425,631
Turkish Lira	-	18,968,168	3,301,243	-
Uruguayan Peso	-	4,198,906	-	-
Foreign Investments denominated in U.S. Dollars	156,024,241	193,333,780	185,440,988	61,898,196
	<u>2,346,576,036</u>	<u>832,282,402</u>	<u>2,329,869,123</u>	<u>415,070,013</u>

## Illinois State Board of Investment

### Notes to Financial Statements

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#### Note 2. Deposits, Investments, and Investment Risk (Continued)

##### Securities Lending

ISBI participates in a securities lending program with Credit Suisse AG, New York Branch who acts as securities lending agent. Securities are loaned to brokers and, in return, ISBI receives cash and non-cash collateral. All of the securities are eligible for the securities lending program. Collateral consists solely of cash and government securities having a fair value equal to or exceeding 102% of the value of the loaned securities (105% for non-U.S. securities). In the event of borrower default, Credit Suisse AG, New York Branch provides ISBI with counterparty default indemnification. Investments in the cash collateral account represent securities that were distributed to ISBI in connection with the in-kind redemption of ISBI's ownership in the State Street Bank and Trust Company Quality Funds for Short-Term Investment (Quality D). Credit Suisse is not responsible for any losses with regards to these legacy investments. This arrangement subjects ISBI to credit risk as the credit quality of these investments may decline over time. The credit risk on the legacy investments is the risk of a possible loss arising from the inability of a counterparty to meet its obligations. This loss could include the loss of principal, interest and/or decreased expected cash flows in any of the investments held in ISBI's cash collateral account. In the event a counterparty defaults on its obligations, ISBI would need to credit the cash collateral account with the amount of the default to make the account whole so that once loaned securities are returned, the cash pledged by borrowers can be returned to them. As of June 30, 2014 and 2013, the collateral received exceeded the fair value of the securities loaned. As of June 30, 2014 and 2013, there were outstanding loaned securities having fair values of \$168,534,354 and \$238,382,734, respectively; against which collateral was received with a fair value of \$182,644,281 and \$245,131,637, respectively. Collateral received at June 30, 2014 and 2013 consisted of \$61,409,324 and \$61,530,842, respectively, in cash and \$121,234,957 and \$183,600,796, respectively, in government securities for which ISBI does not have the ability to pledge or sell.

The cash collateral received is invested in a short-term instrument having a fair value of \$60,114,354 and \$59,160,611 as of June 30, 2014 and 2013, respectively. This investment pool had an average duration of 23.86 days and 29.80 days as of June 30, 2014 and 2013, respectively. Any decrease in the fair value of invested cash collateral is recorded as unrealized losses and reported as a component of the investment income/loss on the Statements of Changes in Net Position.

##### Derivative Securities

In fiscal year 2010, ISBI implemented GASB Statement No. 53 *Accounting and Financial Reporting for Derivative Instruments* with respect to investments held in derivative securities. A derivative security is an investment whose payoff depends upon the value of other assets such as commodity prices, bond and stock prices, or a market index. ISBI invests in derivative instruments including forward foreign currency contracts, futures, rights and warrants. ISBI's derivatives are considered investment derivatives.

Foreign currency forward contracts (FX forwards) are used to protect against the currency risk in ISBI's foreign equity portfolio. A foreign currency forward contract is an agreement to buy or sell a specific amount of a foreign currency at a specified delivery or maturity date for an agreed-upon price. Fluctuations in the market value of foreign currency forward contracts are marked to market on a daily basis. These investments are reported at fair value in the investment section of the Statements of Changes in Net Position. The gain or loss arising from the difference between the original contracts and the closing of such contracts is recognized in the net increase/decrease in the fair value of investments in the Statements of Changes in Net Position. In May 2011, ISBI removed language from the investment management agreements allowing managers to hedge foreign currencies and/or to hedge equity positions.

## Illinois State Board of Investment

### Notes to Financial Statements

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#### **Note 2. Deposits, Investments, and Investment Risk (Continued)**

ISBI investment managers use financial futures to replicate an underlying security they wish to hold (sell) in the portfolio. In certain instances, it may be beneficial to own a futures contract rather than the underlying security (arbitrage). Additionally, financial futures are used in the ISBI fixed income portfolio to adjust portfolio strategy and overall portfolio duration. A financial futures contract is an agreement to buy or sell a specific amount at a specified delivery or maturity date for an agreed-upon price. The fair values of the futures contract vary from the original contract price, a gain or loss is recognized and paid to or received from the clearinghouse. The gain or loss is recognized in the net increase/decrease in the fair value of investments in the Statements of Change in Net Position. Financial futures represent an off-balance sheet obligation, as there are no balance sheet assets or liabilities associated with those contracts. The cash or securities to meet these obligations are held in the investment portfolio.

ISBI investment managers use options in an attempt to add value to the portfolio (collect premiums) or protect (hedge) a position in the portfolio. Financial options are an agreement that gives one party the right, but not the obligation, to buy or sell a specific amount of an asset for a specified price, called the strike price, on or before a specified expiration date. As a writer of financial options, ISBI receives a premium at the outset of the agreement and bears the risk of an unfavorable change in the price of the financial instrument underlying the option. All written financial options are recognized as a liability on ISBI's financial statements. As a purchaser of financial options, ISBI pays a premium at the outset of the agreement and the counterparty bears the risk of an unfavorable change in the price of the financial instrument underlying the option. The gain or loss associated with options is recognized in the net increase/decrease in the fair value of investments in the Statements of Changes in Net Position.

Rights and warrants allow ISBI investment managers to replicate an underlying security they wish to hold (sell) in the portfolio. Rights and warrants provide the holder with the right, but not the obligation, to buy or sell a company's stock at a predetermined price. Rights usually expire after a few weeks and warrants can expire from one to several years. Under certain circumstances, a type of warrant called Participatory Notes (P-Notes) are used in the portfolio by ISBI investment managers that are not registered to trade in domestic Indian Capital Markets. P-Notes are issued by Indian based brokerage firms against an underlying Indian security permitting holders to get a share in the income from the security. These investments are reported at fair value in the investment section of the Statements of Net Position within the common stock and foreign equity classifications. The gain or loss associated with rights and warrants is recognized in the net increase/decrease in the fair value of investments in the Statements of Changes in Net Position.

The fair values of the forward contracts are estimated based on the present value of their estimated future cash flows. Futures contracts are exchange traded instruments where the fair value is determined by the equilibrium between the forces of supply and demand. The fair value of a right or warrant closely tracks the intrinsic value of the underlying stock and can be determined either by formulaic methodology (most commonly Black-Scholes) or intrinsic value methodology.

**Illinois State Board of Investment**

**Notes to Financial Statements**

**Note 2. Deposits, Investments, and Investment Risk (Continued)**

The following table presents the investment derivative instruments aggregated by type that were held by ISBI as of June 30, 2014 and 2013:

	Changes in Fair Value		Fair Value at Year End		Notional Amount	
	2014	2013	2014	2013	2014	2013
	\$	\$	\$	\$	Number of shares	Number of shares
FX forwards	(4,557,072)	(2,963,240)	(637,600)	(412,825)	N/A	N/A
Futures	N/A	N/A	N/A	N/A	(19,492,453)	25,076,117
Options	(9,152,466)	6,068,549	(2,635,570)	9,078,690	3,450,575	8,040,934
Rights	687,576	(655,303)	21,258	22,104	32,233	35,139
Warrants	43,476	3,331,121	145,805	18	77,375	1
	<u>\$ (12,978,487)</u>	<u>\$ 5,781,127</u>	<u>\$ (3,106,107)</u>	<u>\$ 8,687,987</u>	<u>(15,932,270)</u>	<u>33,152,191</u>

The table below shows the futures positions held by ISBI as of June 30, 2014 and 2013.

	2014		2013	
	Number of Contracts	Contract Principal*	Number of Contracts	Contract Principal*
		\$		\$
Equity futures purchased	984	94,707,150	1,398	113,135,073
Fixed income futures purchased	500	58,038,549	723	94,816,672
Fixed income futures sold	519	90,728,863	371	66,975,628

\* Contract principal amounts shown represent the market value of the underlying assets the contracts control. Contract principal is shown to present the volume of the transactions but does not reflect the extent to which positions may offset one another. These amounts do not represent the much smaller amounts potentially subject to risk. Contract principal values also do not represent actual values reported in the Statement of Net Position.

Derivative transactions involve, to varying degrees, credit risk and market risk. Credit risk is the possibility that a loss may occur because a party to a transaction fails to perform according to terms. Derivatives which are exchange traded are not subject to credit risk. No derivatives held are subject to custodial credit risk. Market risk is the possibility that a change in interest (interest rate risk) or currency rates (foreign currency risk) will cause the value of a financial instrument to decrease or become more costly to settle. The market risk associated with derivatives, the prices of which are constantly fluctuating, is regulated by imposing strict limits as to the types, amounts and degree of risk that investment managers may undertake. These limits are approved by the Board of Trustees and management of ISBI and the risk positions of the investment managers are reviewed on a periodic basis to monitor compliance with the limits. As of June 30, 2014 and June 30, 2013, respectively, ISBI held futures contracts whose underlying instruments were exposed to interest risk but there were no GASB 53 reportable elements. The ISBI has not adopted a formal policy specific to master netting arrangements.

Illinois State Board of Investment

Notes to Financial Statements

**Note 2. Deposits, Investments, and Investment Risk (Continued)**

ISBI's derivative investments in foreign currency forward contracts are held with counterparties. The credit ratings and net exposure as of June 30, 2014 and 2013 for the counterparties are as follows:

Moody's Rating	2014			2013		
	Fair Value	Net Exposure	Percentage of Net Exposure	Fair Value	Net Exposure	Percentage of Net Exposure
	\$	\$	%	\$	\$	%
Aa3	31,958	31,958	5.47	196,480	196,480	26.97
Aa2	135,731	135,731	23.22	68,353	68,353	9.39
A3	-	-	-	198,724	198,724	27.28
A2	291,685	291,685	49.89	106,379	106,379	14.61
A1	2,450	2,450	0.42	92,066	92,066	12.64
Baa1	16,943	16,943	2.90	66,323	66,323	9.11
Baa2	105,781	105,781	18.10	-	-	-
	<u>584,548</u>	<u>584,548</u>	<u>100.00</u>	<u>728,325</u>	<u>728,325</u>	<u>100.00</u>

Illinois State Board of Investment

Notes to Financial Statements

**Note 2. Deposits, Investments, and Investment Risk (Continued)**

The following table presents the fair value of derivative investments exposed to foreign currency risk as of June 30, 2014 and 2013:

	2014				2013			
	FX Forwards	Rights	Warrants	Options	FX Forwards	Rights	Warrants	Options
	\$	\$	\$	\$	\$	\$	\$	\$
Australian Dollar	(10,223)	-	-	-	7,424	1,571	-	-
Brazilian Real	(468,235)	-	-	-	7,385	-	-	-
Canadian Dollar	18,701	-	-	-	(43,143)	-	-	397,444
Chilean Peso	(2,651)	-	-	-	6,394	-	-	-
Columbian Peso	(65,342)	-	-	-	-	-	-	-
Czech Koruna	(3,596)	-	-	-	7,402	-	-	-
Danish Krone	(2,479)	-	-	-	9,832	-	-	-
Egyptian Pound	-	-	-	-	(137)	-	-	-
English Pound								
Sterling	(15,658)	-	-	-	(99,137)	-	-	2,107,735
Euro Currency	(109,012)	8,011	140,436	-	95,900	18,101	-	2,062,912
Hong Kong Dollar	(455)	-	4,326	-	321	3	-	-
Hungarian Forint	3,661	-	-	-	-	-	-	-
Indian Ruppe	(40,098)	-	-	-	-	-	-	-
Indonesian Rupiah	6,912	-	-	-	-	-	-	-
Israeli Shekel	(1,833)	-	-	-	1,440	-	-	-
Japanese Yen	125,773	-	-	-	(533,639)	-	-	-
Malaysian Ringgit	(7,300)	11,665	-	-	2,157	-	-	-
Mexican Peso	4,770	-	-	-	14,205	-	-	-
New Zealand Dollar	1,912	-	-	-	25,808	-	-	-
Norwegian Krone	(2,286)	-	-	-	48,222	-	-	-
Peruvian Noveau Sol	3,634	-	-	-	-	-	-	-
Polish Zloty	13,381	-	-	-	(6,005)	-	-	-
Russian Ruble	72,949	-	-	-	-	-	-	-
Singapore Dollar	(3,924)	-	-	-	(25,115)	-	-	-
South African Rand	(44,578)	-	-	-	11,768	-	-	-
South Korean Won	(20,558)	-	-	-	(31,319)	-	-	-
Swedish Krona	7,769	-	-	-	16,622	-	-	-
Swiss Franc	(65,602)	-	-	-	72,344	-	-	-
Taiwan Dollar	6,992	-	-	-	-	-	-	-
Thailand Baht	(944)	-	-	-	(1,555)	-	-	-
Turkish Lira	(8,039)	-	-	-	-	-	-	-
Yuan Renminbi	(31,241)	-	-	-	-	-	-	-
Investments denominated in U.S Dollars	-	1,043	1,582	(2,635,570)	-	2,429	18	4,510,599
	<u>(637,600)</u>	<u>20,719</u>	<u>146,344</u>	<u>(2,635,570)</u>	<u>(412,826)</u>	<u>22,104</u>	<u>18</u>	<u>9,078,690</u>

**Illinois State Board of Investment**

**Notes to Financial Statements**

**Note 3. Member Systems' and Trust Fund Participation**

	General Assembly	Judges'	State Employees'	Illinois State Board of Investment Member Systems	Illinois Power Agency Trust Fund	Total Illinois State Board of Investment*
	\$	\$	\$	\$	\$	\$
<b>Member Systems' Income and Expenses</b>						
<b>Fiscal Year Ended June 30, 2014</b>						
Interest and dividends	1,499,303	20,166,571	396,094,900	417,760,774	918,739	418,679,513
Net securities lending income	11,489	156,652	3,066,998	3,235,139	7,093	3,242,232
Net increase in fair value of investments	6,988,375	91,689,469	1,809,958,589	1,908,636,433	4,202,702	1,912,839,135
Total investment income	8,499,167	112,012,692	2,209,120,487	2,329,632,346	5,128,534	2,334,760,880
Administrative expenses	(153,577)	(2,059,317)	(40,473,085)	(42,685,979)	(93,849)	(42,779,828)
Net investment income	8,345,590	109,953,375	2,168,647,402	2,286,946,367	5,034,685	2,291,981,052
<b>Member Systems' Changes in Net Position</b>						
<b>Fiscal Year Ended June 30, 2014</b>						
Net position at beginning of year	49,003,784	612,751,563	12,176,459,191	12,838,214,538	28,242,698	12,866,457,236
Member Systems' net withdrawals	(5,800,000)	16,000,000	(58,607,580)	(48,407,580)	(655,333)	(49,062,913)
Net investment income	8,345,590	109,953,375	2,168,647,402	2,286,946,367	5,034,685	2,291,981,052
Net position at end of year	51,549,374	738,704,938	14,286,499,013	15,076,753,325	32,622,050	15,109,375,375

The source of net position of the member systems since inception at June 30, 2014, is as follows:

Member Systems' net contributions (withdrawals)	(80,650,878)	(131,885,969)	(1,862,826,847)	(2,075,363,694)	24,152,729	(2,051,210,965)
Accumulated net investment income	132,200,252	870,590,907	16,149,325,860	17,152,117,019	8,469,321	17,160,586,340
Net position at fair value	51,549,374	738,704,938	14,286,499,013	15,076,753,325	32,622,050	15,109,375,375

\* Combined column for the Member Systems and Trust Fund is presented for information purposes only and does not indicate that the assets of one system or trust fund may be used for another system or trust fund.



**Illinois State Board of Investment**

**Notes to Financial Statements**

**Note 3. Member Systems' and Trust Fund Participation (Continued)**

	General Assembly	Judges'	State Employees'	Illinois State Board of Investment Member Systems	Illinois Power Agency Trust Fund	Total Illinois State Board of Investment*
	\$	\$	\$	\$	\$	\$
<b>Member Systems' Income and Expenses</b>						
<b>Fiscal Year Ended June 30, 2013</b>						
Interest and dividends	1,472,533	17,679,120	347,043,392	366,195,045	807,067	367,002,112
Net securities lending income	18,884	228,197	4,493,066	4,740,147	10,444	4,750,591
Net increase in fair value of investments	5,138,885	60,728,747	1,185,000,651	1,250,868,283	2,700,515	1,253,568,798
Total investment income	6,630,302	78,636,064	1,536,537,109	1,621,803,475	3,518,026	1,625,321,501
Administrative expenses	(151,663)	(1,823,780)	(35,850,179)	(37,825,622)	(83,390)	(37,909,012)
Net investment income	6,478,639	76,812,284	1,500,686,930	1,583,977,853	3,434,636	1,587,412,489
<b>Member Systems' Changes in Net Position</b>						
<b>Fiscal Year Ended June 30, 2013</b>						
Net position at beginning of year	49,025,145	559,139,279	10,675,772,261	11,283,936,685	-	11,283,936,685
Member Systems' net contributions (withdrawals)	(6,500,000)	(23,200,000)	-	(29,700,000)	24,808,062	(4,891,938)
Net investment income	6,478,639	76,812,284	1,500,686,930	1,583,977,853	3,434,636	1,587,412,489
Net position at end of year	49,003,784	612,751,563	12,176,459,191	12,838,214,538	28,242,698	12,866,457,236

The source of net position of the member systems since inception at June 30, 2013, is as follows:

Member Systems' net contributions (withdrawals)	(74,850,878)	(147,885,969)	(1,804,219,267)	(2,026,956,114)	24,808,062	(2,002,148,052)
Accumulated net investment income	123,854,662	760,637,532	13,980,678,458	14,865,170,652	3,434,636	14,868,605,288
Net position at fair value	49,003,784	612,751,563	12,176,459,191	12,838,214,538	28,242,698	12,866,457,236

\* Combined column for the Member Systems and Trust Fund is presented for information purposes only and does not indicate that the assets of one system or trust fund may be used for another system or trust fund.

**Note 4. Pensions**

**Plan Description**

All of ISBI employees participate in the State Employees' Retirement System (SERS), which is a pension trust fund in the State of Illinois reporting entity. The SERS is a single-employer, defined-benefit, public employee retirement system (PERS) in which State employees participate, except those covered by the State Universities, Teachers', General Assembly, and Judges' Retirement Systems. The financial position and results of operations of the SERS for fiscal years 2014 and 2013 are included in the State of Illinois' Comprehensive Annual Financial Report (CAFR). The SERS also issues a separate CAFR that may be obtained by writing to the SERS, 2101 South Veterans Parkway, P.O. Box 19255, Springfield, IL 62794-9255 or by calling 217/785-7444. The State of Illinois CAFR may be obtained by writing to the State Comptroller's Office, Financial Reporting Department, 325 West Adams Street, Springfield, IL 62704-1858 or by calling 217/782-6000.

## Illinois State Board of Investment

### Notes to Financial Statements

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#### **Note 4. Pensions (Continued)**

A summary of SERS' benefit provisions, changes in benefit provisions, employee eligibility requirements including eligibility for vesting, and the authority under which benefit provisions are established, are included as an integral part of the SERS' CAFR. Also included is a discussion of employer and employee obligations to contribute, and the authority under which those obligations are established.

#### **Funding Policy**

ISBI pays employer retirement contributions based upon an actuarially determined percentage of payroll. For fiscal year 2014 and 2013, the employer contribution rates were 40.312% and 37.987%, respectively. ISBI contributions to SERS for fiscal years 2014 and 2013 were \$461,173 and \$461,809, respectively, and were equal to the required contributions for each fiscal year.

Effective for pay periods beginning after December 31, 1991, the Board opted to pay the employee portion of retirement for ISBI employees covered by the State Employees' Retirement Systems. Generally, this pickup of employee retirement was part of the budget process and was, in part, a substitute for salary increases. In November 2010 the Board amended the policy to pay the employee portion of retirement to only apply to current employees as of the date of the policy change. New employees from that date forward must pay their own employee portion of retirement contributions. ISBI contributions to SERS for the employee portion for fiscal years 2014 and 2013 were \$40,575 and \$41,161, respectively.

#### **Member System Contributions and Withdrawals**

Member systems' contributions are comprised solely of proceeds from bonds issued by the State of Illinois. As required by Public Act 96-1497, the State of Illinois issued \$3.7 billion of General Obligation Bonds, Taxable Bond Series February 2011 on March 10, 2011 at an interest rate of 5.56%. The net bond proceeds were allocated among the five state-funded retirement systems to reduce their actuarial reserve deficiencies as provided in the Act. The State Employees' Retirement System, General Assembly Retirement System, and Judges' Retirement System received an allocation of bond proceeds equal to \$745,546,496 on March 14, 2011. The monies were deposited into the Master Trust Account with the Illinois State Board of Investment the same day. The monies were combined with ISBI's other investments and invested in accordance with the asset allocation policy of ISBI during the year ended June 30, 2011. In fiscal year 2014, the Judges' Retirement System made contributions of \$16,000,000. Member systems' withdrawals are determined by the member retirement systems based on the State's funding, the systems' benefit payment needs and the ability for ISBI to liquidate available assets. The total withdrawals for fiscal years 2014 and 2013 were \$65,062,913 and \$29,792,192, respectively.

#### **Post-retirement Benefits**

The State provides health, dental, and life insurance benefits for retirees and their dependents in a program administered by the Department of Healthcare and Family Services along with the Department of Central Management Services. Substantially all State employees become eligible for post-employment benefits if they eventually become annuitants of one of the State sponsored pension plans. Health, dental and vision benefits include basic benefits for annuitants under the State's self-insurance plan and insurance contracts currently in force. Annuitants may be required to contribute towards health, dental and vision benefits with the amount based on factors such as date of retirement, years of credited service with the State, whether the annuitant is covered by Medicare, and whether the annuitant has chosen a managed health care plan. Annuitants who retired prior to January 1, 1998, and who are vested in the State Employees' Retirement System, do not contribute toward health, dental and vision benefits. For annuitants who retired on or after January 1, 1998, the annuitant's contribution amount is reduced five percent for each year of credited service with the State allowing those annuitants with twenty or more years of credited service to not have to contribute towards health, dental and vision benefits. Annuitants also receive life insurance coverage equal to the annual salary of the last day of employment until age 60, at which time the benefits become \$5,000.

## Illinois State Board of Investment

### Notes to Financial Statements

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#### **Note 4. Pensions (Continued)**

The total cost of the State's portion of health, dental, vision and life insurance benefits of all members including post-employment health, dental, vision and life insurance benefits, is recognized as an expenditure by the State in the Illinois Comprehensive Annual Financial Report. The State finances the cost on a pay-as-you-go basis. The total costs incurred for health, dental, vision and life insurance benefits are not separated by department or component unit for annuitants and their dependents nor active employees and their dependents.

A summary of post-employment benefit provisions, changes in benefit provisions, employee eligibility requirements including eligibility for vesting, and the authority under which benefit provisions are established are included as an integral part of the financial statements of the Department of Healthcare and Family Services. A copy of the financial statements of the Department of Healthcare and Family Services may be obtained by writing to the Department of Healthcare and Family Services, 201 South Grand Ave. East, Springfield, Illinois 62763-3838.

#### **Note 5. New Governmental Accounting Standards**

Statement No. 68, *Accounting and Financial Reporting for Pensions*, will be effective for ISBI beginning with its year ended June 30, 2015. This statement requires governments providing defined benefit pensions to recognize their long-term obligation for pension benefits as a liability for the first time, and to more comprehensively and comparably measure the annual costs of pension benefits. This statement also enhances accountability and transparency through revised and new note disclosures and required supplementary information (RSI).

Statement No. 71, *Pension Transition for Contributions Made Subsequent to the Measurement Date – an amendment of GASB Statement No. 68*, will be effective for ISBI beginning with its year ended June 30, 2015. This statement is to improve accounting and financial reporting by addressing an issue in Statement No. 68, *Accounting and Financial Reporting for Pensions*, concerning transition provisions related to certain pension contributions made to defined benefit pension plans prior to implementation of that Statement by employers and non-employer contributing entities. The provisions of this statement should be applied simultaneously with the provisions of GASB Statement No. 68.

Management has not yet completed its assessment of these statements; however, it is not expected to have a material effect on the overall financial statement presentation.



**Independent Auditors' Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards**

Honorable William G. Holland  
Auditor General  
State of Illinois

Board of Trustees  
Illinois State Board of Investment

As Special Assistant Auditors for the Auditor General, we have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States, the Statements of Net Position and Statements of Changes in Net Position of the Illinois State Board of Investment Member Systems (ISBI Member Systems), as of and for the years ended June 30, 2014 and June 30, 2013, and the Statements of Net Position of its investment trust fund, the Illinois Power Agency Trust Fund (Trust Fund), as of June 30, 2014 and June 30, 2013, and the Statements of Changes in Net Position for the years ended June 30, 2014 and June 30, 2013, which collectively comprise the Illinois State Board of Investment's (ISBI) basic financial statements, and have issued our report thereon dated December 2, 2014.

**Internal Control Over Financial Reporting**

In planning and performing our audit of the financial statements, we considered ISBI's internal control over financial reporting (internal control) to determine the audit procedures that are appropriate in the circumstances for the purpose of expressing our opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of ISBI's internal control. Accordingly, we do not express an opinion on the effectiveness of ISBI's internal control.

*A deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. *A material weakness* is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. *A significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Our consideration of internal control was for the limited purpose described in the first paragraph of this section and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies. Given these limitations, during our audit we did not identify any deficiencies in internal control that we consider to be material weaknesses. However, material weaknesses may exist that have not been identified.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether ISBI's financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

**Purpose of this Report**

The purpose of this report is solely to describe the scope of our testing of internal control and compliance and results of that testing, and not to provide an opinion on the effectiveness of ISBI's internal control or on compliance. This report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering ISBI's internal control and compliance. Accordingly, this communication is not suitable for any other purpose.

*McGladrey LLP*

Schaumburg, Illinois  
December 2, 2014