# ILLINOIS STATE BOARD OF INVESTMENT

**An Internal Investment Pool of the State of Illinois**

Financial Statements

June 30, 2007 and 2006

(With Independent Auditors' Report Thereon)

Performed as Special Assistant Auditors
For the Auditor General, State of Illinois

**Illinois State Board of Investment**
**An Internal Investment Pool of the State of Illinois**

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## FINANCIAL STATEMENT REPORT

## SUMMARY

The audit of the accompanying financial statements of the Illinois State Board of Investment was performed by KPMG LLP.

Based on their audit, the auditors expressed an unqualified opinion on the Board's basic financial statements.

**KPMG LLP**
303 East Wacker Drive
Chicago, IL 60601-5212

## Independent Auditors' Report

Honorable William G. Holland
Auditor General
State of Illinois

Board of Directors
Illinois State Board of Investment

As Special Assistant Auditors for the Auditor General, we have audited the accompanying statements of net assets of the Illinois State Board of Investment (Board), an internal investment pool of the State of Illinois, as of June 30, 2007 and 2006, and the related statements of changes in net assets for the years then ended. These financial statements are the responsibility of the Board's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Board's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Illinois State Board of Investment as of June 30, 2007 and 2006, and the changes in its net assets for the years then ended, in conformity with U.S. generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated January 15, 2008 on our consideration of the Board'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 the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

The accompanying management's discussion and analysis on pages 5 through 6 is not a required part of the basic financial statements but is supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

Chicago, Illinois
January 15, 2008

**KPMG LLP**
303 East Wacker Drive
Chicago, IL 60601-5212

# 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 Directors
Illinois State Board of Investment

As Special Assistant Auditors for the Auditor General, we have audited the basic financial statements of the Illinois State Board of Investment (the Board), an internal investment pool of the State of Illinois, as of and for the year ended June 30, 2007, and have issued our report thereon dated January 15, 2008. We conducted our audit 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.

## Internal Control over Financial Reporting

In planning and performing our audit, we considered the Board's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing an opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Board's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Board's internal control over financial reporting.

A control deficiency 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 misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether the Board's financial statements are free of 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*.

This report is intended solely for the information and use of the Auditor General, the General Assembly, the Legislative Audit Commission, the Governor, the Illinois State Board of Investment Board of Directors, and the Board's management and is not intended to be and should not be used by anyone other than these specified parties.

KPMG LLP

Chicago, Illinois
January 15, 2008

The following Management Discussion and Analysis (MD&A) provides an introduction and overview of the Illinois State Board of Investment (ISBI or Board) financial activities for the fiscal years ended June 30, 2007 and 2006.

**Financial Highlights**
The net assets of the Board totaled approximately $12.6 billion at fiscal year ended June 30, 2007, compared to $11.3 billion at fiscal year ended June 30, 2006. The increase is a result of strong investment returns, but was tempered by member systems' withdrawals.

**Overview of the Financial Statements**
The Board'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 Statement of Net Assets, the Statement of Changes in Net Assets and Notes to Financial Statements.

The Statements of Net Assets presents information on the Board's assets and liabilities and the resulting net assets. This statement also reflects the Board's investments at fair value, along with the cash and short-term investments, receivables and other assets and liabilities.

The increase in investments at June 30, 2007 is a result of an investment gain of 17.1% for the fiscal year, net of expenses, offset by member withdrawals which are shown in the Statement of Changes in Net Assets. The gain reflects double digit returns in private equity, international and domestic equities and real estate. Distributions received from private equity and real estate partnerships resulted in a decrease in the cash for fiscal year 2007. The increase in liabilities for fiscal 2007 compared with 2006 consisted mainly of security lending collateral obligations and an increase in unsettled investment purchases.

The increase in investments at June 30, 2006 was a result of an investment gain of 11.0% for the fiscal year, net of expenses which are shown in the Statement of Changes in Net Assets. The gain reflected a significant improvement in market environments, in particular real estate, private equity investments, international equity and fixed income. Distributions received from private equity and real estate partnerships resulted in an increase in the cash for fiscal year 2006. The increase in liabilities for fiscal 2006 compared with 2005 consisted mainly of unsettled investment purchases.

The Statements of Changes in Net Assets presents information regarding changes during the fiscal years ended June 30, 2007 and 2006. This statement reflects additions, which include the investment income derived from realized and unrealized gains/losses, member system contributions, and income received from securities lending activities. Also reflected in the statement are deductions, which include withdrawals from the member systems and operating expenses of the Board.

**Condensed Summary of Net Assets**

| | Fiscal Years Ended June 30 | | | 2007/2006 | 2006/2005 |
|---|---|---|---|---|---|
| | 2007 | 2006 | 2005 | Change | Change |
| | $ | $ | $ | $ | $ |
| Cash | 42,916,419 | 80,644,137 | 13,722,061 | (37,727,718) | 66,922,076 |
| Receivables | 548,269,714 | 184,529,093 | 294,208,301 | 363,740,621 | (109,679,208) |
| Investments | 12,805,770,746 | 11,434,818,360 | 10,959,676,010 | 1,370,952,386 | 475,142,350 |
| Securities lending collateral | 2,084,820,497 | 1,530,783,382 | 1,444,871,284 | 554,037,115 | 85,912,098 |
| Capital assets | 49,283 | 45,348 | 41,772 | 3,935 | 3,576 |
| Prepaid expenses | 14,740 | 18,984 | 0 | (4,244) | 18,984 |
| Total assets | 15,481,841,399 | 13,230,839,304 | 12,712,519,428 | 2,251,002,095 | 518,319,876 |
| Liabilities | 2,929,645,238 | 1,914,354,450 | 1,810,039,761 | 1,015,290,788 | 104,314,689 |
| Total net assets | 12,552,196,161 | 11,316,484,854 | 10,902,479,667 | 1,235,711,307 | 414,005,187 |

The net investment gains of the ISBI fund in fiscal year 2007 were the result of a positive movement in the securities markets. Member system withdrawals decreased compared to fiscal year 2006. Fiscal year 2007 withdrawals were $642 million compared with $759 million in fiscal year 2006 and $547.7 million in fiscal year 2005. Withdrawals are determined by the member retirement systems based on the State's funding and the systems' benefit payment needs. The increase in operating expenses for fiscal year 2007 versus 2006 was mainly a result of increased investment management fees due to additional assets under management and an increase in due diligence services for the alternative investments portfolio.

The net investment gains of the ISBI fund in fiscal year 2006 were the result of a positive movement in the securities markets. There was a substantial increase in withdrawals by the member systems. Fiscal year 2006 withdrawals were $759 million compared with $547.7 million in fiscal year 2005. Withdrawals are determined by the member retirement systems based on the State's funding and the systems' benefit payment needs. The increase in operating expenses for fiscal year 2006 versus 2005 was mainly a result of increased investment management fees due to additional assets under management. Operating expenses increased slightly in fiscal year 2006 over 2005 by $5.6 million, mainly due to the use of hedged fund of funds, with sizeable management fees, and the increased use of active managers.

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

**Condensed Summary of Changes in Net Assets**

| | Fiscal Years Ended June 30 | | | 2007/2006 | 2006/2005 |
|---|---|---|---|---|---|
| | 2007 | 2006 | 2005 | Change | Change |
| | $ | $ | $ | $ | $ |
| Additions: | | | | | |
| Net investment income | 1,918,274,641 | 1,203,147,819 | 1,031,923,322 | 715,126,822 | 171,224,497 |
| Member systems' contributions | 0 | 0 | 0 | 0 | 0 |
| Total additions | 1,918,274,641 | 1,203,147,819 | 1,031,923,322 | 715,126,822 | 171,224,497 |
| Deductions: | | | | | |
| Member systems' withdrawals | 642,000,000 | 759,000,000 | 547,700,000 | (117,000,000) | 211,300,000 |
| Administrative expenses | 40,563,334 | 30,142,632 | 24,482,209 | 10,420,702 | 5,660,423 |
| Total deductions | 682,563,334 | 789,142,632 | 572,182,209 | (106,579,298) | 216,960,423 |
| Net increase in net assets | 1,235,711,307 | 414,005,187 | 459,741,113 | 821,706,120 | (45,735,926) |

| | 2007 | 2006 |
|---|---|---|
| | $ | $ |
| ASSETS | | |
| Cash and cash equivalents | 42,916,419 | 80,644,137 |
| Receivables: | | |
| Foreign taxes | 1,071,202 | 775,140 |
| Account receivables | 940,118 | 757,957 |
| Investments sold | 509,107,369 | 146,174,012 |
| Interest & dividends | 37,151,025 | 36,821,984 |
| Total receivables | 548,269,714 | 184,529,093 |
| Prepaid expenses | 14,740 | 18,984 |
| Capital assets | 49,283 | 45,348 |
| Investments at fair value: | | |
| Government and agency obligations | 1,184,275,884 | 1,110,919,988 |
| Foreign obligations | 72,189,687 | 104,455,671 |
| Corporate obligations | 1,228,970,012 | 1,382,574,163 |
| Common stock & equity funds | 6,059,409,027 | 5,369,124,032 |
| Preferred stock | 1,865,020 | 1,057,334 |
| Foreign equity securities | 1,365,647,941 | 1,113,268,102 |
| Hedge funds | 496,404,578 | 416,462,183 |
| Real estate investments | 1,189,614,911 | 1,134,025,154 |
| Private equity | 563,366,021 | 482,264,036 |
| Money market instruments | 535,699,912 | 320,641,552 |
| Infrastructure funds | 108,436,449 | 0 |
| Forward foreign currency contracts | (108,696) | 26,145 |
| Total investments | 12,805,770,746 | 11,434,818,360 |
| Securities lending collateral | 2,084,820,497 | 1,530,783,382 |
| Total assets | 15,481,841,399 | 13,230,839,304 |
| LIABILITIES | | |
| Payables: | | |
| Investments purchased | 837,252,239 | 376,678,007 |
| Operating expenses | 7,572,502 | 6,893,061 |
| Securities lending cash collateral obligation | 2,084,820,497 | 1,530,783,382 |
| Total liabilities | 2,929,645,238 | 1,914,354,450 |
| Net assets | 12,552,196,161 | 11,316,484,854 |

*See notes to financial statements, pages 9-19.*

| | 2007 | 2006 |
|---|---|---|
| | $ | $ |
| ADDITIONS | | |
| Investment income | | |
| Net increase in fair value of investments | 1,594,268,871 | 892,599,986 |
| Interest | 172,400,021 | 183,047,403 |
| Dividends | 147,112,290 | 123,178,718 |
| Securities lending income | 93,596,872 | 64,090,764 |
| Less securities lending rebates | (88,310,386) | (58,968,999) |
| Less securities lending expenses | (793,027) | (800,053) |
| Total net investment income | 1,918,274,641 | 1,203,147,819 |
| Member systems' contributions | 0 | 0 |
| Total additions | 1,918,274,641 | 1,203,147,819 |
| DEDUCTIONS | | |
| Expenses: | | |
| Salaries and benefits: | | |
| Salaries | 932,787 | 863,802 |
| Benefits | 344,237 | 309,578 |
| Operating expenses: | | |
| Rent and utilities | 153,559 | 160,139 |
| Audit | 132,630 | 105,450 |
| Other | 161,867 | 147,616 |
| External support: | | |
| Custody | 239,800 | 224,730 |
| Consulting and professional | 1,133,726 | 739,748 |
| Investment advisors/managers | 37,297,370 | 27,434,504 |
| Investment services and research | 167,358 | 157,065 |
| Total expenses | 40,563,334 | 30,142,632 |
| Member systems' withdrawals | 642,000,000 | 759,000,000 |
| Total deductions | 682,563,334 | 789,142,632 |
| Increase in net assets | 1,235,711,307 | 414,005,187 |
| Net assets at beginning of year | 11,316,484,854 | 10,902,479,667 |
| Net assets at end of year | 12,552,196,161 | 11,316,484,854 |

*See notes to financial statements, pages 9-19.*

*Note A*
*Summary of Significant Accounting Policies*

**Reporting Entity**
The Illinois State Board of Investment (ISBI or Board) is considered to be an internal investment pool of the State of Illinois, operating solely from investment income. The ISBI manages and invests the pension assets of three separate public employee retirement systems: General Assembly Retirement System, the Judges' Retirement System of Illinois, and State Employees' Retirement System of Illinois.

The assets of the member systems are accounted for in a single Commingled Fund. Separate information on each system's participation is presented in Note C.

**Basis of Accounting**
Accounting records are maintained on an accrual basis. Shares are allocated monthly to member systems based upon percentage of ownership. Management expenses are deducted monthly from income before distribution.

**Valuation of Investments**
Investments owned are reported at fair value as follows: (1) U.S. Government and Agency, Foreign and Corporate Obligations – prices quoted by a major dealer in such securities; (2) Common Stock and Equity Funds, 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 it's investment managers; and (5) Alternative Investments (Private Equity, Hedge Funds and Infrastructure Funds ) Investments – fair values as determined by ISBI and it's investment managers.

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

**Custody and Investment Management Fees**
Custody fees for the period July 1, 2005 through November 30, 2005 were computed quarterly with a base charge for all accounts. Subsequent to November 30, 2005 there were no base charges for custody fees.

Investment management fees for all accounts, except real estate and private equity, are computed quarterly as a percentage of each manager's portfolio market value. Management fees for real estate and alternative investments are not directly charged but are included in the investment income for these investments.

**Risk Management**
The 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. The 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 statement of net assets.

**Use of Estimates**
In preparing financial statements in conformity with U.S. generally accepted accounting principles, the Board 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.

**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. Cash held in the investment related bank account is neither insured nor collateralized for amounts in excess of $100,000. During fiscal year 2007, a Credit Risk Policy was implemented by ISBI staff and formally adopted by the Board 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. State Street Bank and Trust has an AA long-term deposit/debt rating by Standards & Poor's and an Aa1 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 of less. For financial statement presentation and investment purposes, ISBI reports its cash equivalents as Money Market Instruments in the Statements of Net Assets.

| | 2007 | 2006 |
|---|---|---|
| | $ | $ |
| Carrying amounts at June 30 | | |
| Cash | 42,916,419 | 80,644,137 |
| Bank balances at June 30 | | |
| Total | 43,068,157 | 80,724,748 |
| Amount exposed to custodial credit risk | 42,920,664 | 80,566,513 |

**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 A, ISBI currently manages and invests the assets of the General Assembly Retirement System, Judges' Retirement System, and State Employees' Retirement System. 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.

40ILCS 5/1-109 requires all members of the Board 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 $369 million and $400 million, as of June 30, 2007 and 2006, respectively. Also, at the end of fiscal years 2007 and 2006, the Board had outstanding commitments of $311 million and $567 million, respectively to separate real estate accounts.

*Note B (continued)*
*Deposits, Investments, and Investment Risk Disclosures*

**Investment Summary**
The following table presents a summary of the Fund's investments at fair value by type at June 30, 2007 and 2006:

| | 2007 | 2006 |
|---|---|---|
| | $ | $ |
| Government and agency obligations | 1,184,275,884 | 1,110,919,988 |
| Foreign obligations | 72,189,687 | 104,455,671 |
| Corporate obligations | 1,228,970,012 | 1,382,574,163 |
| Common stock & equity funds | 6,059,409,027 | 5,369,124,032 |
| Preferred stock | 1,865,020 | 1,057,334 |
| Foreign equity securities | 1,365,647,941 | 1,113,268,102 |
| Hedge funds | 496,404,578 | 416,462,183 |
| Real estate investments | 1,189,614,911 | 1,134,025,154 |
| Private equity | 563,366,021 | 482,264,036 |
| Money market instruments | 535,699,912 | 320,641,552 |
| Infrastructure funds | 108,436,449 | 0 |
| Forward foreign currency contracts | (108,696) | 26,145 |
| Total investments | 12,805,770,746 | 11,434,818,360 |

**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 an outside party. As of June 30, 2007 and 2006, the following investments were uninsured and unregistered, with securities held by the counterparty or by its trust department or agent but not in the Board's name:

| | 2007 | 2006 |
|---|---|---|
| | $ | $ |
| Common stock | 3,423,509 | 7,540,275 |
| Government and agency obligations | 28,351,415 | 43,932,397 |
| Corporate obligations | 2,152,096 | 4,649,641 |
| Total | 33,927,020 | 56,122,313 |

**Concentration of Credit Risk and Credit Risk for Investments**
The portfolio 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. The Board did not have any single issuer investment that exceeded 5% of the total net assets of the fund as of June 30, 2007 and 2006. The following table presents the quality ratings of debt securities held by ISBI as of June 30, 2007 and 2006:

| | Moody's Quality Rating | 2007 | 2006 |
|---|---|---|---|
| | | $ | $ |
| Government and agency obligations | | | |
| U.S. Government obligations | AAA | 317,358,768 | 457,091,471 |
| Federal agency obligations | AAA | 866,917,116 | 651,140,066 |
| Municipal | AAA | 0 | 2,688,451 |
| Total Government and agency obligations | | 1,184,275,884 | 1,110,919,988 |
| Foreign obligations | AAA | 16,064,111 | 16,124,526 |
| | AA | 4,407,275 | 4,040,041 |
| | A | 5,363,202 | 16,276,367 |
| | BAA | 17,202,270 | 27,419,722 |
| | BA | 15,153,571 | 12,024,660 |
| | B | 3,348,055 | 19,290,811 |
| | CAA | 0 | 1,274,200 |
| | Not rated | 10,651,203 | 8,005,344 |
| Total foreign obligations | | 72,189,687 | 104,455,671 |
| Corporate obligations | AAA | 254,534,185 | 324,130,117 |
| | AA | 122,242,182 | 144,481,958 |
| | A | 132,484,746 | 148,904,618 |
| | BAA | 111,327,503 | 115,363,940 |
| | BA | 183,959,419 | 238,778,065 |
| | B | 262,208,497 | 274,358,266 |
| | CAA | 50,779,805 | 14,129,168 |
| | CA | 907,309 | 682,031 |
| | C | 683,890 | 461,236 |
| | Not rated | 109,842,476 | 121,284,764 |
| Total corporate obligations | | 1,228,970,012 | 1,382,574,163 |

*Note B (continued)*
*Deposits, Investments, and Investment Risk Disclosures*

**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 average rate between 80 and 120 percent of the benchmark index.

Duration is a 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 full price. The effective duration measures the sensitivity of market price to parallel shifts in the yield curve. ISBI benchmarks its debt security portfolio to the Lehman Brothers Aggregate. At June 30, 2007 and 2006, the effective duration of the Lehman Brothers Aggregate was 3.7 and 3.6 years, respectively. At the same points in time, the effective duration of the ISBI debt security portfolio at June 30, 2007 and 2006 was 3.3 and 3.8 years, respectively.

| | 2007 | | 2006 | |
|---|---|---|---|---|
| | Fair Value | Effective Weighted Duration Years | Fair Value | Effective Weighted Duration Years |
| Investment Type | $ | | $ | |
| Government & agency obligations | | | | |
| U.S. Treasury | 317,358,768 | 4.8 | 457,091,471 | 4.4 |
| Federal Agency | 866,917,116 | 1.6 | 651,140,066 | 3.3 |
| Municipal | 0 | N/A | 2,688,451 | 4.8 |
| Foreign Obligations | 72,189,687 | 4.5 | 104,455,671 | 5.1 |
| Corporate Obligations | | | | |
| Finance | 256,092,972 | 3.7 | 306,124,824 | 3.4 |
| Industrials | 531,051,552 | 5.1 | 580,581,651 | 4.7 |
| Mortgage Backed Securities | 170,384,277 | 2.4 | 211,686,803 | 2.1 |
| Other | 247,762,105 | 3.6 | 243,467,599 | 5.5 |
| Commingled Funds | 23,679,106 | N/A | 40,713,286 | NA |
| | 2,485,435,583 | | 2,597,949,822 | |

**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. The following table presents the foreign currency risk by type of investment as of June 30, 2007 and 2006:

| | 2007 | | 2006 | |
|---|---|---|---|---|
| | Foreign Equity Securities | Foreign Obligations | Foreign Equity Securities | Foreign Obligations |
| | $ | $ | $ | $ |
| Australian Dollar | 72,095,189 | 0 | 45,031,863 | 0 |
| Canadian Dollar | 25,401,638 | 671,932 | 27,309,690 | 0 |
| Danish Krone | 14,131,867 | 0 | 11,811,080 | 0 |
| English Pound Sterling | 245,374,152 | 0 | 208,671,160 | 0 |
| Euro Currency | 434,344,665 | 0 | 298,835,278 | 2,773,684 |
| Hong Kong Dollar | 49,855,829 | 0 | 48,639,162 | 0 |
| Iceland Krona | 0 | 2,274,574 | 0 | 0 |
| Japanese Yen | 276,514,350 | 4,526,106 | 272,057,458 | 0 |
| Malaysian Ringgit | 0 | 5,818,897 | 0 | 0 |
| Mexican Peso | 0 | 4,468,150 | 0 | 147,648 |
| New Zealand Dollar | 0 | 1,492,263 | 767,645 | 2,205,864 |
| Norwegian Krone | 13,319,542 | 0 | 9,864,745 | 0 |
| Singapore Dollar | 24,082,058 | 5,774,393 | 9,200,224 | 0 |
| South African Rand | 0 | 2,954,509 | 0 | 0 |
| South Korean Won | 29,407,763 | 0 | 22,537,972 | 0 |
| Swedish Krona | 33,723,011 | 0 | 29,340,607 | 0 |
| Swiss Franc | 69,190,076 | 0 | 54,417,316 | 0 |
| Foreign Investments denominated in US dollars | 78,207,801 | 44,208,863 | 74,783,902 | 99,328,475 |
| Total | 1,365,647,941 | 72,189,687 | 1,113,268,102 | 104,455,671 |

*Note B (continued)*
*Deposits, Investments, and Investment Risk Disclosures*

**Securities Lending**
ISBI participates in a securities lending program with State Street who acts as securities lending agent. Securities are loaned to brokers and, in return, the Board has rights to a portion of a collateral pool. All of the securities are eligible for the securities lending program. Collateral consists solely of cash, letters of credit, commercial paper 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, State Street provides ISBI with counterparty default indemnification. ISBI had no credit risk as a result of its securities lending program as the collateral held exceeded the fair value of the securities lent. As of June 30, 2007 and 2006 there were outstanding loaned investment securities having fair values of $2,129,513,426 and $1,568,683,721 respectively; against which collateral was received with a fair value of $2,189,767,674 and $1,597,656,445 respectively. Collateral received at June 30, 2007 and 2006 consisted of $2,084,820,497 and $1,530,783,382, respectively, in cash and $104,947,177 and $66,873,063, respectively, in securities for which ISBI does not have the ability to pledge or sell.

**Derivative Securities**
Some of ISBI's managers invest in derivative securities. A derivative security is an investment whose payoff depends upon the value of other assets such as bond and stock prices, a market index, or commodity prices. ISBI's investments in derivatives are not leveraged. Obligations to purchase (long a financial future or a call option) are held in cash or cash equivalents. In the case of obligations to sell (short a financial future or a put option), the reference security is held in the portfolio. Derivatives 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. Market risk is the possibility that a change in interest or currency rates 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. The Board and senior management approve these limits, and the risk positions of the investment managers are reviewed on a regular basis to monitor compliance with the limits.

During the year, derivative investments included forward foreign currency contracts, collateralized mortgage obligations (CMO's), futures and options. The remaining derivative securities are used to improve the yields or to hedge changes in interest rates.

Forward foreign currency contracts are used to hedge against the currency risk in ISBI's foreign stock and fixed income portfolios. Forward foreign currency contracts are agreements to buy or sell specific amounts of a foreign currency at a specified delivery or maturity date for an agreed upon price. As the fair value of the forward contracts varies, the Board records an unrealized gain or loss. Forward foreign currency contracts represent an off-balance sheet obligation, as there are no balance sheet assets or liabilities associated with those contracts. The fair value of forward foreign currency contracts outstanding at June 30, 2007 and 2006 were as follows:

| | Cost $ | Fair Value $ | Gain (Loss) $ |
|---|---|---|---|
| June 30, 2007 | | | |
| Forward currency purchases | 1,559,632 | 1,550,171 | (9,461) |
| Forward currency sales | 7,691,150 | 7,790,385 | (99,235) |
| Total gain (loss) | | | (108,696) |
| June 30, 2006 | | | |
| Forward currency purchases | 3,956,106 | 4,008,201 | 52,095 |
| Forward currency sales | 7,860,622 | 7,886,572 | (25,950) |
| Total gain (loss) | | | 26,145 |

ISBI also invests in mortgage-backed securities to maximize yields and to hedge against a rise in interest rates. These securities are based on cash flows from principal and interest payments on underlying mortgages. Therefore, they are sensitive to prepayments by mortgagees, which may result from a decline in interest rates. As of June 30, 2007 and 2006, the fair value of the Board's CMO holdings totaled $170,384,277 and $211,686,803, respectively.

ISBI investment managers utilize financial futures to replicate an underlying security they desire to hold (sell) in the portfolio. In certain instances, it may be beneficial to own a futures contract rather than the underlying security (arbitrage). Financial future contracts are also used to improve the yield or adjust the duration of the portfolio. Financial futures contracts are agreements to buy or sell a specified amount at a specified delivery or maturity date for an agreed upon price. The fair values of the futures contracts vary from the original contract price, a gain or loss is recognized and paid to or received from the clearinghouse. 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.

The Board's investment managers utilize options in an effort to add value to the portfolio (collect premiums) or protect (hedge) a position in the portfolio. Options are agreements that give one party the right, but not the obligation, to buy or sell a specific amount of an asset for a specific price (called the strike price) on or before a specified expiration date. As the 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 instrument underlying the option. As the purchaser, 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 following table shows the futures and options positions held by ISBI as of June 30, 2007 and 2006:

| | 2007 | | 2006 | |
|---|---|---|---|---|
| | Number of Contracts | Contract Principal* $ | Number of Contracts | Contract Principal* $ |
| Domestic | | | | |
| Equity futures purchased | 2,169 | 168,891,330 | 2,667 | 190,210,548 |
| Fixed income futures purchased | 609 | 77,268,953 | 1,605 | 269,684,894 |
| Fixed income futures sold | 1,333 | 248,776,093 | 355 | 37,149,313 |
| Fixed income written put options | 78 | 33,000,000 | 71 | 7,100,000 |
| Fixed income written call options | 209 | 74,900,000 | 320 | 122,900,000 |
| Eurocurrency purchased call options | 0 | 0 | 23,550,000 | 23,550,000 |
| Fixed income purchased put options | 0 | 0 | 58 | 58,000,000 |
| Fixed income purchased call options | 241 | 241,000,000 | 0 | 0 |

* Contract principal amounts shown represent the fair value of the underlying assets the contracts control. These are shown to present the volume of the transactions but do 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 recorded values

| *Note C*<br>*Member Systems' Participation* | General Assembly | Judges' | State Employees' | Combined* |
|---|---|---|---|---|
| **Member Systems' Income and Expenses Fiscal Year Ended June 30, 2007** | $ | $ | $ | $ |
| Interest and dividends | 2,178,065 | 16,622,551 | 300,711,695 | 319,512,311 |
| Net securities lending income | 30,586 | 233,876 | 4,228,997 | 4,493,459 |
| Net increase in fair value of investments | 10,914,976 | 82,846,751 | 1,500,507,144 | 1,594,268,871 |
| Management expenses | (275,426) | (2,113,844) | (38,174,064) | (40,563,334) |
| Net investment income | 12,848,201 | 97,589,334 | 1,767,273,772 | 1,877,711,307 |
| **Member Systems' Changes in Net Assets Fiscal Year Ended June 30, 2007** | | | | |
| Net assets at beginning of year | 79,016,741 | 582,604,390 | 10,654,863,723 | 11,316,484,854 |
| Member systems' net (withdrawals) | (8,000,000) | (22,000,000) | (612,000,000) | (642,000,000) |
| Net investment income | 12,848,201 | 97,589,334 | 1,767,273,772 | 1,877,711,307 |
| Net assets at end of year | 83,864,942 | 658,193,724 | 11,810,137,495 | 12,552,196,161 |

The source of net assets of the member systems since inception at June 30, 2007, is as follows:

| | | | | |
|---|---|---|---|---|
| Member systems' net (withdrawals) | (38,159,495) | (39,932,730) | (846,086,756) | (924,178,981) |
| Accumulated net investment income | 122,024,437 | 698,126,454 | 12,656,224,251 | 13,476,375,142 |
| Net assets at fair value | 83,864,942 | 658,193,724 | 11,810,137,495 | 12,552,196,161 |

** Combined column for the member systems is presented for information purposes only and does not indicate that the assets of one system may be used for another system.*

| *Note C* *Member Systems' Participation* | General Assembly | Judges' | State Employees' | Combined* |
|---|---|---|---|---|
| **Member Systems' Income and Expenses Fiscal Year Ended June 30, 2006** | $ | $ | $ | $ |
| Interest and dividends | 2,137,981 | 15,763,229 | 288,324,911 | 306,226,121 |
| Net securities lending income | 30,173 | 222,464 | 4,069,075 | 4,321,712 |
| Net increase in fair value of investments | 5,786,233 | 46,320,241 | 840,493,512 | 892,599,986 |
| Management expenses | (210,447) | (1,551,615) | (28,380,570) | (30,142,632) |
| Net investment income | 7,743,940 | 60,754,319 | 1,104,506,928 | 1,173,005,187 |
| **Member Systems' Changes in Net Assets Fiscal Year Ended June 30, 2006** | | | | |
| Net assets at beginning of year | 80,772,801 | 550,350,071 | 10,271,356,795 | 10,902,479,667 |
| Member systems' net (withdrawals) | (9,500,000) | (28,500,000) | (721,000,000) | (759,000,000) |
| Net investment income | 7,743,940 | 60,754,319 | 1,104,506,928 | 1,173,005,187 |
| Net assets at end of year | 79,016,741 | 582,604,390 | 10,654,863,723 | 11,316,484,854 |

The source of net assets of the member systems since inception at June 30, 2006, is as follows:

| | General Assembly | Judges' | State Employees' | Combined* |
|---|---|---|---|---|
| Member systems' net (withdrawals) | (30,159,495) | (17,932,730) | (234,086,756) | (282,178,981) |
| Accumulated net investment income | 109,176,236 | 600,537,120 | 10,888,950,479 | 11,598,663,835 |
| Net assets at fair value | 79,016,741 | 582,604,390 | 10,654,863,723 | 11,316,484,854 |

** Combined column for the member systems is presented for information purposes only and does not indicate that the assets of one system may be used for another system.*

*Note D*
*Pensions*

**Plan Description**
All of the 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 2007 and 2006 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 Veterans Parkway, Springfield, IL 62794-9255 or by calling 217/785-7202. The State of Illinois CAFR may be obtained by writing to the Office of the Comptroller, Financial Reporting Department, 325 West Adams Street, Springfield, IL 62704-1858 or by calling 217/782-2053.

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 years 2007 and 2006 the employer contribution rates were 11.525% and 7.792% respectively. ISBI contributions to SERS for fiscal years 2007 and 2006 were $111,777 and $69,384, respectively, and were equal to the required contributions for each fiscal year. Effective for pay periods beginning after December 31, 1991, the State opted to pay the employee portion of retirement for most State agencies with employees covered by the State Employees' and Teachers' Retirement Systems. Generally, this "pickup" of employee retirement was part of the budget process and was, in part, a substitute for salary increases. The pickup is subject to sufficient annual appropriations and those employees covered may vary across employee groups and State agencies. Currently, State officers, judges, general assembly members, and State university employees are not eligible for the employee pickup.

**Post-employment Benefits**
In addition to providing pension benefits, the State provides certain health, dental and life insurance benefits to annuitants who are former State employees. This includes annuitants of the ISBI. Substantially all State employees may become eligible for post-employment benefits if they eventually become annuitants. Health and dental benefits include basic benefits for annuitants under the State's self-insurance plan and insurance contracts currently in force. Life insurance benefits are limited to five thousand dollars per annuitant age 60 and older.

Costs incurred for health, dental and life insurance for annuitants and their dependents were not separated from benefits that were provided to active employees and their dependents for the years ended June 30, 2007 and 2006. However, post-employment costs for the State as a whole for all State agencies or departments for dependent health, dental and life insurance for annuitants and their dependents are disclosed in the State's Comprehensive Annual Financial Report. Cost information for retirees by individual State agency is not available. Payments are made on a "pay-as-you-go" basis.