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

Financial Statements
June 30, 2016
(With Independent Auditors' Report Thereon)
Performed as Special Assistant Auditors
for the Auditor General, State of Illinois

ILLINOIS STATE BOARD OF INVESTMENTS
(An Internal Investment Pool of the State of Illinois)

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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 financials statements of the Illinois State Board of Investment (ISBI) as of and for the year ended June 30, 2016 were performed by KPMG LLP. Based on their audits, the auditors expressed an unmodified opinion on ISBI's basic financial statements.

## Summary of Findings

| Number of: | Current Report | Prior Year Report |
|---|---|---|
| Findings | None | 1 |
| Repeated findings | None | None |
| Prior recommendations implemented or not repeated | 1 | None |

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# Independent Auditors' Report

The Honorable Frank J. Mautino
Auditor General of the State of Illinois
and
The Board of Trustees
Illinois State Board of Investment

## Report on the Financial Statements

As Special Assistant Auditors for the Auditor General of the State of Illinois, we have audited the accompanying Statement of Net Position of the Illinois State Board of Investment (ISBI), an internal investment pool of the State of Illinois as of June 30, 2016, and the related Statement of Changes in Net Position for the year then ended and the related notes to the financial statements. We have also audited ISBI's investment trust funds, the Illinois State Board of Investment Member Systems and the Illinois Power Agency Trust Funds (the Trust Funds) as of and for the year ending June 30, 2016. ISBI and the Trust Funds collectively comprise the basic financial statements as listed in the accompanying 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 U.S. generally accepted accounting principles; 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 audit. 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. Those standards require that we plan and perform the audit 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 and the Trust Funds, as of June 30, 2016, and the changes in net position for the year then ended, in accordance with U.S. generally accepted accounting principles.

***Emphasis of Matter***

As discussed in note 2 to the financial statements, in 2016, ISBI and the Trust Funds adopted Governmental Accounting Standards Board (GASB) Statement No. 72, *Fair Value Measurement and Application*. Our opinions are not modified with respect to this matter.

***Other Matters***

*Required Supplementary Information*

U.S. generally accepted accounting principles 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 21, 2016 on our consideration of the ISBI and Trust Funds' 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 ISBI and Trust Funds' internal control over financial reporting and compliance.

**SIGNED ORIGINAL ON FILE**

Chicago, Illinois
December 21, 2016

## Management's Discussion and Analysis

In October 1969, the Illinois State Board of Investment (ISBI) was created by enactment of Article 22A of the Illinois Pension Code by the 76th 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, 2016 and 2015.

### Financial Highlights

The net position of ISBI totaled approximately $15.6 billion at fiscal year end June 30, 2016, compared to approximately $15.8 billion at June 30, 2015. The decrease from the previous year is primarily the result of investment losses.

### 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 Statement of Net Position, the Statement of Changes in Net Position and Notes to Financial Statements.

The Statement 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 decrease in investments at June 30, 2016 is a result of an investment loss of (0.84%) for the fiscal year, net of expenses which are shown in the Statement of Changes in Net Position. The increase in liabilities for fiscal 2016 compared with 2015 is consistent with a large amount of investment purchases at year-end to rebalance the portfolio. This increase in investment payables was a result of the rebalancing of the portfolio and updates to the asset allocation due to approval of Meketa Investment Group retained as a result of an RFP for General Consulting services. As consistent with the Investment Policy of ISBI, the conclusion of that process automatically triggers a new asset allocation study. Meketa Investment Group put forth Asset Allocation recommendations that were approved at the ISBI January 2016 Board meeting.

The Statement of Changes in Net Position present information regarding changes during the fiscal year ended June 30, 2016. 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
June 30

| | 2016 | 2015 | Change |
|---|---|---|---|
| | $ | $ | $ |
| Cash | 5,995,894 | 14,210,878 | (8,214,984) |
| Receivables | 1,105,425,096 | 632,521,317 | 472,903,779 |
| Investments | 15,565,546,970 | 15,831,411,636 | (265,864,666) |
| Securities lending collateral | 16,123,651 | 31,096,392 | (14,972,741) |
| Prepaid expenses | 24,266 | 11,588 | 12,678 |
| Capital assets | 58,634 | 41,223 | 17,411 |
| Total assets | 16,693,174,511 | 16,509,293,034 | 183,881,477 |
| Liabilities | 1,091,505,986 | 663,399,484 | 428,106,502 |
| Total net position | 15,601,668,525 | 15,845,893,550 | (244,225,025) |

The net investment losses for the year ended June 30, 2016 were the result of downward movement in the securities markets. There was an increase in withdrawals by the member systems. Fiscal year 2016 withdrawals were $117.2 million compared with $5.4 million in fiscal year 2015. Withdrawals are determined by the member retirement systems based on the State of Illinois' funding and the Member Systems' benefit payment needs. The decrease in administrative expenses for fiscal year 2016 compared to 2015 is due to a revision in the asset allocation moving the portfolio towards indexed passively managed funds which results in a reduction of investment management fees.

Condensed Statement of Changes in Net Position

Fiscal Years Ended June 30

| | 2016 | 2015 | Change |
|---|---|---|---|
| | $ | $ | $ |
| Additions: | | | |
| Net investment income | (93,019,465) | 765,107,482 | (858,126,947) |
| Contributions from the State of Illinois | 6,637,155 | 21,400,460 | (14,763,305) |
| Total additions | (86,382,310) | 786,507,942 | (872,890,252) |
| Deductions: | | | |
| Member systems' withdrawals | 117,200,000 | 5,350,000 | 111,850,000 |
| Administrative expenses | 40,642,715 | 44,639,767 | (3,997,052) |
| Total deductions | 157,842,715 | 49,989,767 | 107,852,948 |
| Net increase (decrease) in net position | (244,225,025) | 736,518,175 | (980,743,200) |

## 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 September 15, 2016 Board meeting of the Illinois State Board of Investment Northern Trust Company was hired to become the Custodian for the pension systems and Illinois Power Agency Trust Fund assets. This change will be effective January 1, 2017.

**Illinois State Board of Investment**

**Statement of Net Position**
**June 30, 2016**

| | Illinois State Board of Investment Member Systems | Illinois Power Agency Trust Fund | Total Illinois State Board of Investment |
|---|---|---|---|
| **ASSETS** | | | |
| Cash | $ 5,983,276 | $ 12,618 | $ 5,995,894 |
| Receivables: | | | |
| Foreign taxes | 5,241,216 | 11,053 | 5,252,269 |
| Accounts receivable | 302,508 | 638 | 303,146 |
| Investments sold | 1,061,822,008 | 2,239,288 | 1,064,061,296 |
| Interest and dividends | 35,733,027 | 75,358 | 35,808,385 |
| Total receivables | 1,103,098,759 | 2,326,337 | 1,105,425,096 |
| Prepaid expenses | 24,216 | 50 | 24,266 |
| Capital assets | 51,986 | 110 | 52,096 |
| Capital lease | 6,524 | 14 | 6,538 |
| Investments: | | | |
| Measured at fair value: | | | |
| Government and agency obligations | 2,344,083,456 | 4,943,463 | 2,349,026,919 |
| Foreign obligations | 79,996,581 | 168,706 | 80,165,287 |
| Corporate obligations | 744,965,954 | 1,571,067 | 746,537,021 |
| Common stock and equity funds | 4,308,822,674 | 9,086,927 | 4,317,909,601 |
| Commingled funds | 959,707,049 | 2,023,937 | 961,730,986 |
| Foreign equity securities | 2,238,874,109 | 4,721,586 | 2,243,595,695 |
| Foreign preferred stock | 427,157 | 901 | 428,058 |
| Hedge funds | 1,178,717,448 | 2,485,810 | 1,181,203,258 |
| Real estate funds | 1,700,478,688 | 3,586,158 | 1,704,064,846 |
| Private equity | 581,716,569 | 1,226,788 | 582,943,357 |
| Real assets | 591,488,982 | 1,247,398 | 592,736,380 |
| Bank loans | 448,978,405 | 946,856 | 449,925,261 |
| Foreign currency forward contracts | (1,334,605) | (2,815) | (1,337,420) |
| Measured at amortized cost: | | | |
| Money market instruments | 355,867,229 | 750,492 | 356,617,721 |
| Total investments | 15,532,789,696 | 32,757,274 | 15,565,546,970 |
| Securities lending collateral | 16,089,719 | 33,932 | 16,123,651 |
| Total assets | 16,658,044,176 | 35,130,335 | 16,693,174,511 |
| **LIABILITIES** | | | |
| Payables: | | | |
| Investments purchased | 1,065,804,090 | 2,247,686 | 1,068,051,776 |
| Administrative expenses | 6,080,652 | 12,824 | 6,093,476 |
| Capital Lease Obligation | 6,621 | 14 | 6,635 |
| Securities lending cash collateral obligation | 17,317,578 | 36,521 | 17,354,099 |
| Total liabilities | 1,089,208,941 | 2,297,045 | 1,091,505,986 |
| Net position | 15,568,835,235 | 32,833,290 | 15,601,668,525 |

*See notes to financial statements, pages 9 - 25.*

**Illinois State Board of Investment**

**Statement of Changes in Net Position**
**June 30, 2016**

| | Illinois State Board of Investment Member Systems | Illinois Power Agency Trust Fund | Total Illinois State Board of Investment |
|---|---|---|---|
| **ADDITIONS** | | | |
| Investment income: | | | |
| Net decrease in fair value | | | |
| of investments | $ (567,302,770) | $ (1,193,581) | $ (568,496,351) |
| Interest and other | 296,708,907 | 624,045 | 297,332,952 |
| Dividends | 174,764,176 | 367,568 | 175,131,744 |
| Securities lending income | 3,401,217 | 7,158 | 3,408,375 |
| Securities lending rebates | (61,368) | (129) | (61,497) |
| Securities lending expense | (333,985) | (703) | (334,688) |
| Total investment income | (92,823,823) | (195,642) | (93,019,465) |
| Contributions from the State of Illinois | 6,500,000 | 137,155 | 6,637,155 |
| Total additions | (86,323,823) | (58,487) | (86,382,310) |
| **DEDUCTIONS** | | | |
| Administrative expenses: | | | |
| Salaries and benefits: | | | |
| Salaries | 1,203,401 | 2,528 | 1,205,929 |
| Benefits | 887,432 | 1,865 | 889,297 |
| Operating expenses: | | | |
| Rent and utilities | 156,649 | 330 | 156,979 |
| Audit | 202,313 | 425 | 202,738 |
| Other | 226,801 | 477 | 227,278 |
| External support: | | | |
| Custody | 245,833 | 517 | 246,350 |
| Consulting and professional | 1,549,089 | 3,255 | 1,552,344 |
| Investment advisors/managers | 35,841,596 | 75,304 | 35,916,900 |
| Investment services and research | 244,388 | 512 | 244,900 |
| Total administrative expenses | 40,557,502 | 85,213 | 40,642,715 |
| Member Systems' withdrawals | 116,000,000 | 1,200,000 | 117,200,000 |
| Total deductions | 156,557,502 | 1,285,213 | 157,842,715 |
| Increase in net position | (242,881,325) | (1,343,700) | (244,225,025) |
| Net position at beginning of year | 15,811,716,560 | 34,176,990 | 15,845,893,550 |
| Net position at end of year | 15,568,835,235 | 32,833,290 | 15,601,668,525 |

*See notes to financial statements, pages 9 - 25.*

## 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 Member Systems and Trust Fund are reported as investment trust funds 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 Member Systems and Trust Fund are reported on the Statement of Net Position. The revenues and expenses for the Member Systems and Trust Fund for fiscal year 2016 are reported on the Statement 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 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 – amortized cost; (4) Real Estate Investments – fair values based on audited financial statements of the funds and then adjusted by ISBI and its investment managers for activity from audit date to fiscal year end; (5) Alternative Investments (Private Equity, Hedge funds, Bank Loans and Real Assets) – fair values based on audited financial statements of the funds and then adjusted by ISBI and its investment managers for activity from audit date to fiscal year end; (6) Commingled funds – fair values based on audited financial statements of the funds and then adjusted by ISBI and its investment managers for activity from audit date to fiscal year end.

**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 Statement 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 Statement of Changes in Net Position. Certain other infrastructure fund fees are reported net of investment income on the Statement of Changes in Net Position.

### 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 assets managed by ISBI. These services include safekeeping and transaction processing services for all pension assets of the Member Systems and the Trust Fund. 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 Statement 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 Statement of Net Position and the annual increase or decrease in the liability is reflected in the Salaries Expense on the Statement of Changes in Net Position.

## 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.

**Capital Lease Obligation**
ISBI has entered into a capital lease for office equipment. The capital lease is for a 60 month term with a purchase option for fair market value at the end of the lease period. Future minimum commitments for capital the capital lease as of June 30, 2016 are as follows:

| Capital Lease Year Ending June 30 | Principal $ | Interest $ |
|---|---|---|
| 2017 | 2,666 | 2,185 |
| 2018 | 2,666 | 1,412 |
| 2019 | 2,666 | 1,078 |
| 2020 | 2,666 | 656 |
| 2021 | 1,776 | 149 |
| | 12,440 | 5,480 |

**Implementation of Accounting Standards**
ISBI implemented Governmental Accounting Standards Board Statement No. 72, *Fair Value Measurement and* Application (GASB No. 72), which defines fair value and requires disclosure and classification of ISBI's financial instruments in accordance with the fair value hierarchy based upon the manner in which the financial instrument is valued. There was no impact on ISBI's net position as a result of implementing GASB No. 72.

## Note 2. Deposits, Investments, Investment Risk, and Fair Value

**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, 2016, ISBI had non-investment related bank balances of $393,683. 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 and Deutsche Bank AG, NY Branch. State Street Bank and Trust Company has an AA- Long-term Deposit/Debt rating by Standard & Poor's and an Aa1 rating by Moodys. 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 Statement of Net Position. As of June 30, 2016, ISBI had investment related bank balances of $5,602,210. 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.

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

**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.

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**
ISBI had total investment commitments of $561 million at the end of fiscal years 2016. Real Estate and Private Equity investment portfolios consist of passive interests in limited partnerships. ISBI had outstanding commitments to these limited partnerships of approximately $489 million as of June 30, 2016. At the end of fiscal year 2016, ISBI had no outstanding commitments to separate real estate accounts within the Real Estate and Private Equity investment portfolios. Also at the end of fiscal year 2016, ISBI had outstanding commitments of $72 million for real assets. ISBI will fund outstanding commitments by utilizing available cash and then selling liquid securities in the portfolio as necessary.

**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, 2016, the annual money-weighted rate of return on pension plan investments, net of pension plan investment expense, was (0.84) 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 was presented to assist the Member Systems to prospectively implement GASB 67 during fiscal year 2014.

**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.

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

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.

### Fair Value Measurements

For the year ended June 30, 2016, ISBI had the following recurring fair value measurements:

| | Fair Value Measurements Using | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Totals |
| **Investments by fair value level** | $ | $ | $ | $ |
| Debt securities | | | | |
| Government and agency obligations | — | 2,349,026,919 | — | 2,349,026,919 |
| Foreign obligations | — | 79,635,747 | 529,540 | 80,165,287 |
| Corporate obligations | — | 743,456,840 | 3,080,181 | 746,537,021 |
| Bank loans | 1,007,807 | 16,740 | 448,900,714 | 449,925,261 |
| Total debt securities | 1,007,807 | 3,172,136,246 | 452,510,435 | 3,625,654,488 |
| Equity securities | | | | |
| Common stock and equity funds | 4,316,613,525 | — | 1,296,076 | 4,317,909,601 |
| Foreign equity securities | 2,236,025,790 | 4,728,166 | 2,841,739 | 2,243,595,695 |
| Foreign preferred stock | 428,058 | — | — | 428,058 |
| Total equity securities | 6,553,067,373 | 4,728,166 | 4,137,815 | 6,561,933,354 |
| Other | | | | |
| Foreign currency forward contracts | — | — | (1,337,420) | (1,337,420) |
| Hedge funds * | — | 376,979,363 | 11,659,156 | 388,638,519 |
| Real estate funds* | — | — | 534,162,163 | 534,162,163 |
| Real assets* | — | — | 2,563,610 | 2,563,610 |
| Total other | — | 376,979,363 | 547,047,509 | 924,026,872 |
| Total investments by fair value level | 6,554,075,180 | 3,553,843,775 | 1,003,695,760 | 11,111,614,714 |
| **Investments measured at the Net Asset Value (NAV)** | | | | |
| Commingled funds | | | | 961,730,986 |
| Real estate | | | | 1,169,902,683 |
| Private equity | | | | 582,943,357 |
| Real assets | | | | 590,172,770 |
| Hedge funds | | | | 792,564,739 |
| Total investments measured at the NAV | | | | 4,097,314,535 |
| **Investments not measured at fair value** | | | | |
| Money market instruments | | | | 356,617,721 |
| Total investments | | | | 15,565,546,970 |
| | **Level 1** | **Level 2** | **Not Applicable**** | **Totals** |
| **Securities Lending Collateral** | 8,832,036 | 5,260,910 | 2,030,705 | 16,123,651 |

*Note: investments are held in separate accounts.
**Note: The category not applicable consists of cash, interest income and tri-party repos which are not subject to leveling.

Fair value is the amount that would be received to sell the investment in an orderly transaction between market participants at the measurement date (i.e. the exit price). Fair value measurements are determined within a framework that utilizes a three-tier hierarchy, which maximizes the use of observable inputs and minimizes the use of unobservable inputs. Investments measured and reported at fair value are classified and disclosed in one of the following categories:

Level 1 – Unadjusted quoted prices in active markets for identical assets.
Level 2 – Inputs other than quoted prices that are observable for the asset, either directly or indirectly. These inputs include:
(a) quoted prices for similar assets in active markets;
(b) quoted prices for identical or similar assets in markets that are not active;
(c) inputs other than quoted prices that are observable for the asset; or
(d) inputs that are derived principally from or corroborated by observable market data by correlation or other means.

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

Level 3 – Inputs that are unobservable for the asset. The valuation of these investments requires significant judgment due to the absence of quoted market values, inherent lack of liquidity, and changes in market conditions.

Valuation methodologies are as follows:

- U.S. Treasuries and U.S. Agencies: quoted prices for identical securities in markets that are not active;
- Foreign Government Obligations and Foreign Corporate Obligations: Brokers quote in an active market;
- Corporate Bonds: quoted prices for similar securities in active markets;
- Bank Loans: discounted cash flow, internal assumptions, weighting of the best available pricing inputs and third party pricing services;
- Common Stock and Equity Funds, Foreign Preferred Stocks, Foreign Equity Securities and Commingled Funds-Domestic and Foreign: quoted prices for identical securities in an active market. Brokers quote in an active market;
- Money Market Funds: Average cost which approximates fair value;
- Derivative instruments: valued using a market approach that considers foreign exchange rates

Investments valued using the net asset value (NAV) per share (or its equivalent) are considered “alternative investments” and, unlike more traditional investments, generally do not have readily obtainable market values and take the form of limited partnerships. ISBI values these investments based on the partnerships’ audited financial statements. If June 30 statements are available, those values are used preferentially. However, some partnerships have fiscal years ending at other than June 30. If June 30 valuations are not available, the value is adjusted from the most recently available valuation taking into account subsequent calls and distributions, adjusted for unrealized appreciation/depreciation, other income and fees. Certain alternative investments are categorized as Level 3 in instances where ISBI owns substantially 100% of the applicable separate account.

The following table presents the unfunded commitments, redemption frequency (if currently eligible), and the redemption notice period for alternative investments measured at NAV:

**Investments Measured at NAV**

| **June 30, 2016** | FAIR VALUE | UNFUNDED COMMITMENTS | REDEMPTION FREQUENCY | REDEMPTION NOTICE PERIOD |
|---|---|---|---|---|
| Commingled funds | 961,730,986 | — | N/A | N/A |
| Real estate | 1,169,902,683 | 205.0 million | Quarterly | 90 days |
| Private equity | 582,943,357 | 284.0 million | Quarterly | 90 days |
| Real assets | 590,172,770 | 72.0 million | N/A | N/A |
| Total investments measured at the NAV | 3,304,749,796 | | | |

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, 2016, real estate equities of approximately $1,704 million are reported at estimated fair value. Of this amount, $1,885 million are net assets offset by $181 million in long-term debt.

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

Required repayment of real estate debt, which is non-recourse debt, is as follows as of June 30, 2016:

| Debt Maturities Year Ending June 30 | $ |
|---|---|
| 2016 | — |
| 2017 | 56,500,000 |
| 2018 | 22,500,000 |
| 2019 | 43,239,761 |
| 2020-2024 | 58,875,000 |
| | 181,114,761 |

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."

**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 have one issuer investment that exceeded 5% of the total investments of ISBI as of June 30, 2016. This security was U.S. Treasury Notes/Bills with a Moody's rating of Aaa. This investment represented 5.9% of the investments of ISBI. At June 30, 2016 ISBI did not have a single issuer investment that exceeded 5% of the total investments of ISBI.

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

The following table presents the quality ratings of debt securities held by ISBI as of June 30, 2016:

| | Moody's Quality Rating | $ |
|---|---|---|
| U.S. government obligations and agency obligations | AAA | 2,349,026,919 |
| | AA | — |
| | A | — |
| | Not rated | — |
| Total U.S. government and agency obligations | | 2,349,026,919 |
| Foreign obligations | AAA | 380,599 |
| | AA | 2,218,831 |
| | A | 15,233,213 |
| | BAA | 9,159,736 |
| | BA | 20,824,887 |
| | B | 21,451,133 |
| | CAA | 6,236,918 |
| | Not rated | 4,659,970 |
| Total foreign obligations | | 80,165,287 |
| Corporate obligations | | |
| Bank and finance | AA | 12,984,272 |
| | A | 87,259,544 |
| | BAA | 62,766,036 |
| | BA | 45,048,390 |
| | B | 14,003,148 |
| | CAA | 7,207,916 |
| | Not rated | 3,859,346 |
| Total bank and finance | | 233,128,652 |
| Industrial | | |
| | AAA | 2,547,505 |
| | AA | 21,831,260 |
| | A | 36,110,999 |
| | BAA | 76,119,486 |
| | BA | 115,386,734 |
| | B | 117,195,788 |
| | CAA | 9,128,425 |
| | CA | 679,770 |
| | Not rated | 9,110,653 |
| Total industrial | | 388,110,620 |
| Other | | |
| | AAA | 2,329,295 |
| | AA | 13,443,171 |
| | A | 11,103,985 |
| | BAA | 20,849,512 |
| | BA | 33,367,395 |
| | B | 40,851,081 |
| | CAA | 3,353,310 |
| | Not rated | — |
| Total other | | 125,297,749 |
| Total corporate obligations | | 746,537,021 |
| Bank loans | | |
| | Not rated | 449,925,261 |
| Total bank loans | | 449,925,261 |
| Money market | | |
| | Not rated | 356,617,721 |
| Total money market | | 356,617,721 |

### 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, 2016, 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.

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

### 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, 2016, ISBI benchmarked its debt security portfolio to Barclay's U.S. Universal Index. At June 30, 2016, the effective duration of the Barclay's U.S. Universal Index was 5.4 years. Below is the detail of the duration by investment type as of June 30, 2016:

| Investment Type | Fair Value | Effective Weighted Duration |
|---|---|---|
| | $ | Years |
| Government and agency | | |
| U.S. government | 1,626,996,131 | 8.4 |
| Federal agency | 722,030,788 | 1.8 |
| Foreign obligations | 80,165,287 | 5.8 |
| Corporate obligations | | |
| Bank and finance | 233,128,652 | 5.8 |
| Industrial | 388,110,620 | 5.2 |
| Other | 125,297,749 | 5.3 |
| | 3,175,729,227 | |

For ISBI bank loans portfolio the appropriate measure of interest rate risk is weighted average maturity. Weighted average maturity is the average time it takes for securities in a portfolio to measure weighted in proportion to the dollar amount that is invested in the portfolio. Weighted average maturity measures the sensitivity of fixed-income portfolios to interest rate changes. At June 30, 2016 the weighted average maturity of ISBI's bank loan portfolio was 4.8 years.

### 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 $51,927,037 as of June 30, 2016. The following table presents the foreign currency risk by type of investment as of June 30, 2016:

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

| | Foreign Equity Securities and Foreign Preferred Stock | Foreign Obligations |
|---|---|---|
| | $ | $ |
| Australian Dollar | 90,105,481 | — |
| Brazilian Real | 20,706,299 | — |
| Canadian Dollar | 91,200,217 | — |
| Colombian Peso | 969,778 | — |
| Czech Koruna | 101,535 | — |
| Danish Krone | 26,423,355 | — |
| Egyptian Pound | 360,559 | — |
| English Pound Sterling | 279,258,238 | — |
| Euro Currency | 560,249,243 | — |
| Hong Kong Dollar | 135,746,605 | — |
| Hungarian Forint | 1,092,049 | — |
| Indonesian Rupiah | 6,200,659 | — |
| Israeli Shekel | 1,248,504 | — |
| Japanese Yen | 379,507,896 | — |
| Malaysian Ringgit | 8,188,031 | — |
| Mexican Peso | 10,281,363 | — |
| New Israeli Sheqel | 889,951 | — |
| New Zealand Dollar | 3,935,677 | — |
| Norwegian Krone | 28,803,019 | — |
| Philippine Peso | 4,005,115 | — |
| Qatari Rial | 1,677,959 | — |
| Singapore Dollar | 31,698,390 | — |
| South African Rand | 15,942,233 | — |
| South Korean Won | 88,449,167 | — |
| Swedish Krona | 55,724,933 | — |
| Swiss Franc | 136,963,837 | — |
| Thailand Baht | 5,651,254 | — |
| UAE Dirham | 1,296,044 | — |
| Foreign Investments denominated in U.S. Dollars | 257,346,362 | 80,165,287 |
| | 2,244,023,753 | 80,165,287 |

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

### Securities Lending

ISBI participates in a securities lending program with Deutsche Bank AG, New York Branch as of June 30, 2016 who acts as securities lending agent. Prior to June 22, 2015 ISBI participated in a securities lending program with Credit Suisse AG, New York Branch who acted 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, Deutsche Bank 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). Deutsche Bank 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, 2016, there were outstanding loaned securities having fair values of $100,576,391; against which collateral was received with a fair value of $102,133,052. Collateral received at June 30, 2016 consisted of $16,123,651 in cash and $86,009,401 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 $16,123,651 as of June 30, 2016. This investment pool had an average duration of 12.13 days as of June 30, 2016. 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 Statement 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 Statement 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 Statement 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.

## Note 2. Deposits, Investments, Investment Risk, and Fair Value (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 Statement 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 Statement 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 Statement 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 Statement 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.

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

The following table presents the investment derivative instruments aggregated by type that were held by ISBI as of June 30, 2016:

| | Changes in Fair Value | Fair Value at Year End | Notional Amount |
|---|---|---|---|
| | $ | $ | Number of shares |
| FX forwards | 4,304,099 | (1,337,420) | N/A |
| Futures | N/A | N/A | (4,454,480) |
| Options | (8,063) | — | — |
| Rights | (16,571) | 73,490 | 632,334 |
| Warrants | (134,625) | — | 67 |
| | 4,144,840 | (1,263,930) | (3,822,079) |

The table below shows the futures positions held by ISBI as of June 30, 2016:

| | Number of Contracts | Contract Principal* |
|---|---|---|
| | | $ |
| Equity futures purchased | 472 | 48,761,577 |
| Fixed income futures purchased | - | - |
| Fixed income futures sold | 1,541 | 138,538,104 |

* 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, 2016, 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.

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

ISBI's derivative investments in foreign currency forward contracts are held with counterparties. ISBI's counterparties were not rated and fair value and net exposure as of June 30, 2016 for these contracts were $678,644.

The following table presents the fair value of derivative investments exposed to foreign currency risk as of June 30, 2016:

| | FX Forwards | Rights | Warrants | Options |
|---|---|---|---|---|
| | $ | $ | $ | $ |
| Australian Dollar | (241,193) | - | - | - |
| Canadian Dollar | (137,931) | - | - | - |
| Danish Krone | (20,836) | - | - | - |
| English Pound Sterling | (115,086) | - | - | - |
| Euro Currency | (317,666) | 36,136 | - | - |
| Hong Kong Dollar | (5,723) | - | - | - |
| Israeli Shekel | (13,812) | - | - | - |
| Japanese Yen | (95,125) | - | - | - |
| Malaysian Ringgit | 2,833 | - | - | - |
| Mexican Peso | (29,456) | - | - | - |
| New Zealand Dollar | (19,332) | 1,213 | - | - |
| Norwegian Krone | (55,740) | - | - | - |
| Singapore Dollar | (16,950) | 34,703 | - | - |
| South African Rand | (76,027) | - | - | - |
| Swedish Krona | (59,673) | - | - | - |
| Swiss Franc | (133,041) | - | - | - |
| Thailand Baht | (2,662) | - | - | - |
| Investments denominated in U.S Dollars | - | 1,438 | - | - |
| | (1,337,420) | 73,490 | - | - |

## 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* |
|---|---|---|---|---|---|---|
| **Member Systems' Income and Expenses** | $ | $ | $ | $ | $ | $ |
| **Fiscal Year Ended June 30, 2016** | | | | | | |
| Interest and dividends | 1,359,565 | 23,769,468 | 446,344,050 | 471,473,083 | 991,613 | 472,464,696 |
| Net securities lending income | 8,647 | 151,603 | 2,845,614 | 3,005,864 | 6,326 | 3,012,190 |
| Net increase in fair value of investments | (1,811,781) | (28,496,533) | (536,994,456) | (567,302,770) | (1,193,581) | (568,496,351) |
| Total investment income | (443,569) | (4,575,462) | (87,804,792) | (92,823,823) | (195,642) | (93,019,465) |
| Administrative expenses | (117,666) | (2,045,207) | (38,394,629) | (40,557,502) | (85,213) | (40,642,715) |
| Net investment income | (561,235) | (6,620,669) | (126,199,421) | (133,381,325) | (280,855) | (133,662,180) |
| **Member Systems' Changes in Net Position** | | | | | | |
| **Fiscal Year Ended June 30, 2016** | | | | | | |
| Net position at beginning of year | 49,165,676 | 795,296,831 | 14,967,254,053 | 15,811,716,560 | 34,176,990 | 15,845,893,550 |
| Member Systems' net withdrawals | (6,000,000) | (3,500,000) | (100,000,000) | (109,500,000) | (1,062,845) | (110,562,845) |
| Net investment income | (561,235) | (6,620,669) | (126,199,421) | (133,381,325) | (280,855) | (133,662,180) |
| Net position at end of year | 42,604,441 | 785,176,162 | 14,741,054,632 | 15,568,835,235 | 32,833,290 | 15,601,668,525 |

The source of net position of the member systems since inception at June 30, 2016, is as follows:

| | General Assembly | Judges' | State Employees' | Illinois State Board of Investment Member Systems | Illinois Power Agency Trust Fund | Total Illinois State Board of Investment* |
|---|---|---|---|---|---|---|
| Member Systems' net contributions (withdrawals) | (91,300,878) | (114,685,969) | (1,962,826,847) | (2,168,813,694) | 23,090,344 | (2,145,723,350) |
| Accumulated net investment income | 133,905,319 | 899,862,131 | 16,703,881,479 | 17,737,648,929 | 9,742,946 | 17,747,391,875 |
| Net position at fair value | 42,604,441 | 785,176,162 | 14,741,054,632 | 15,568,835,235 | 32,833,290 | 15,601,668,525 |

** 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.*

| | General Assembly | Judges' | State Employees' | Illinois State Board of Investment Member Systems | Illinois Power Agency Trust Fund | Total Illinois State Board of Investment* |
|---|---|---|---|---|---|---|
| **Member Systems' Money Weighted Returns** | | | | | | |
| **Fiscal Year Ended June 30, 2016** | 0.32 | (0.57) | (0.86) | n/a | (0.83) | (0.84) |

## 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 year 2015 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.

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 2016, the employer contribution rate was 45.598%. ISBI contributions to SERS for fiscal year 2016 were $569,535 and were equal to the required contribution.

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 year 2016 were $37,704.

**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. The Judges' Retirement System made contributions of $6,500,000 in fiscal year 2016. 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 year 2016 were $116,000,000.

## Note 4. Pensions (Continued)

**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 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.

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 Central Management Services. A copy of the financial statements of the Department of Central Management Services may be obtained by writing to the Department of Central Management Services, 715 Stratton Building, 401 South Spring Street, Springfield, Illinois 62706-4100.

## Note 5. New Governmental Accounting Standards

At this time, Management is not aware of any new accounting standards that will impact the financial statement presentation for its year ended June 30, 2017.

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**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***

The Honorable The Honorable Frank J. Mautino
Auditor General of the State of Illinois
and
The Board of Trustees
Illinois State Board of Investment

As Special Assistant Auditors for the Auditor General of the State of Illinois, 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 financial statements of the Illinois State Board of Investment (ISBI) and its investment trust funds, the Illinois State Board of Investment Member Systems and the Illinois Power Agency Trust Funds (the Trust Funds), which collectively comprise ISBI and the Trust Funds' basic financial statements, and have issued our report thereon dated December 21, 2016.

## Internal Control Over Financial Reporting

In planning and performing our audit of the financial statements, we considered ISBI and the Trust Funds' 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 and the Trust Funds' internal control. Accordingly, we do not express an opinion on the effectiveness of ISBI and the Trust Funds' 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 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 and the Trust Funds' 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*.

KPMG

**Purpose of this Report**

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

SIGNED ORIGINAL ON FILE

Chicago, Illinois
December 21, 2016

**Prior Year Findings Not Repeated**

**Year Ended June 30, 2016**

## A. Inadequate Controls over Financial Close and Reporting

The Illinois State Board of Investment (ISBI) recorded a fiscal year 2016 distribution of $1,200,000 in fiscal year 2015. (Finding Code 2015-001)

In the current year, similar exceptions were not identified in the auditors' testing.