

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

Compliance Examination

Year ended June 30, 2007

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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The annual financial statements of the Illinois State Board of Investment for the year ended June 30, 2007 were issued under a separate cover.

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

Agency Officials

Executive Director

Mr. William R. Atwood

Deputy Executive Director

Ms. Katherine A. Spinato

Illinois State Board of Investment Office is located at:

180 N. LaSalle Street
Suite 2105
Chicago, Illinois 60601



ILLINOIS STATE BOARD OF INVESTMENT

180 North LaSalle Street, Suite 2015
Chicago, Illinois 60601
(312) 793-5718

January 15, 2008

KPMG LLP
303 East Wacker Drive
Chicago, Illinois 60601

Ladies and Gentlemen:

We are responsible for the identification of, and compliance with, all aspects of laws, regulations, contracts, or grants that could have a material effect on the operations of the Illinois State Board of Investment (the Board). We are responsible for and we have established and maintained an effective system of internal controls over compliance requirements. We have performed an evaluation of the Board's compliance with the following assertions during the year ended June 30, 2007. Based on this evaluation, we assert that during the year ended June 30, 2007, the Board has materially complied with the assertions below.

- A. The Board has obligated, expended, received and used public funds of the State in accordance with the purpose for which such funds have been appropriated or otherwise authorized by law.
- B. The Board has obligated, expended, received and used public funds of the State in accordance with any limitations, restrictions, conditions or mandatory directions imposed by law upon such obligation, expenditure, receipt or use.
- C. The Board has complied, in all material respects, with applicable laws and regulations, including the State uniform accounting system, in its financial and fiscal operations.
- D. The State revenues and receipts collected by the Board are in accordance with applicable laws and regulations and the accounting and recordkeeping of such revenues and receipts is fair, accurate and in accordance with law.
- E. The money or negotiable securities or similar assets handled by the Board on behalf of the State or held in trust by the Board have been properly and legally administered, and the accounting and recordkeeping relating thereto is proper, accurate and in accordance with law.

Very truly yours,

Illinois State Board of Investment

William R. Atwood
Executive Director

Katherine A. Spinato
Deputy Executive Director

Emily A. Reid
*General Counsel/
Chief Compliance Officer*

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

Compliance Report

Summary

Year ended June 30, 2007

The compliance testing performed during this examination was conducted in accordance with *Government Auditing Standards* and in accordance with the Illinois State Auditing Act.

Accountants' Reports

The Independent Accountants' Report on State Compliance, on Internal Control over Compliance, and on Supplementary Information for State Compliance Purposes does not contain scope limitations, disclaimers, or other significant nonstandard language.

Summary of Findings

	Compliance Report	Financial Report	Prior Compliance Report
Number of:			
Findings	—	—	3
Repeated findings	—	—	1
Prior recommendations implemented or not repeated	3	—	—

Details of findings are presented in a separately tabbed report section.

Schedule of Findings

Item No.	Page	Description
Current Year Findings:		
None.		
Prior Findings Not Repeated (<i>Government Auditing Standards</i>):		
07 – 1	10	Inadequate Process for Valuation of Alternative Investments
Prior Findings Not Repeated (State Compliance):		
07 – 2	10	Inaccurate Allocation of Investment Earnings
07 – 3	10	Deposit and Investment Custodial Credit Risk

Exit Conference

The Board reviewed the entire report and waived a formal exit conference.



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

**Independent Accountants' Report on State Compliance,
on Internal Control over Compliance, and on
Supplementary Information for State Compliance Purposes**

Honorable William G. Holland
Auditor General
State of Illinois

Board of Directors
Illinois State Board of Investment

Compliance

As Special Assistant Auditors for the Auditor General, we have examined the Illinois State Board of Investment's compliance with the requirements listed below, as more fully described in the Audit Guide for Financial Audits and Compliance Attestation Engagements of Illinois State Agencies (Audit Guide) as adopted by the Auditor General, during the year ended June 30, 2007. The management of the Illinois State Board of Investment (the Board) is responsible for compliance with these requirements. Our responsibility is to express an opinion on the Board's compliance based on our examination.

- A. The Board has obligated, expended, received, and used public funds of the State in accordance with the purpose for which such funds have been appropriated or otherwise authorized by law.
- B. The Board has obligated, expended, received, and used public funds of the State in accordance with any limitations, restrictions, conditions, or mandatory directions imposed by law upon such obligation, expenditure, receipt, or use.
- C. The Board has complied, in all material respects, with applicable laws and regulations, including the State uniform accounting system, in its financial and fiscal operations.
- D. The State revenues and receipts collected by the Board are in accordance with applicable laws and regulations and the accounting and recordkeeping of such revenues and receipts is fair, accurate, and in accordance with law.
- E. Money or negotiable securities or similar assets handled by the Board on behalf of the State or held in trust by the Board have been properly and legally administered and the accounting and recordkeeping relating thereto is proper, accurate, and in accordance with law.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants; the standards applicable to attestation engagements contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; the Illinois State Auditing Act (Act); and the Audit Guide as adopted by the Auditor General pursuant to the Act; and, accordingly, included examining, on a test basis, evidence about the Board's compliance with those requirements listed in the first paragraph of this report and performing such other procedures as we



considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. Our examination does not provide a legal determination on the Board's compliance with specified requirements.

In our opinion, the Illinois State Board of Investment complied, in all material respects, with the requirements listed in the first paragraph of this report during the year ended June 30, 2007.

As required by the Audit Guide, immaterial findings related to instances of noncompliance excluded from this report have been reported in a separate letter to your office.

Internal Control

The management of the Board is responsible for establishing and maintaining effective internal control over compliance with the requirements listed in the first paragraph of this report. In planning and performing our examination, we considered the Board's internal control over compliance with the requirements listed in the first paragraph of this report in order to determine our examination procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with the Audit Guide, issued by the Illinois Office of the Auditor General, but not for the purpose of expressing an opinion on the effectiveness of the Board's internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the Board's internal control over compliance.

A *control deficiency* in an entity's internal control over compliance 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 noncompliance with the requirements listed in the first paragraph of this report on a timely basis. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to comply with the requirements listed in the first paragraph of this report such that there is more than a remote likelihood that noncompliance with a requirement 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 noncompliance with a requirement listed in the first paragraph of this report will not be prevented or detected by the entity's internal control.

Our consideration of internal control over compliance with the requirements listed in the first paragraph of this report 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 compliance that we consider to be material weaknesses, as defined above.

As required by the Audit Guide, immaterial findings related to control deficiencies excluded from this report have been reported in a separate letter to your office.

Supplementary Information for State Compliance Purposes

As Special Assistant Auditors for the Auditor General, we have audited the basic financial statements of the Board as of and for the years ended June 30, 2007 and 2006, and have issued our report thereon dated January 15, 2008. The accompanying supplementary information, as listed in the table of contents as Supplementary Information for State Compliance Purposes, is presented for purposes of additional analysis and is not a required part of the basic financial statements of the Board. Such information, except for that portion marked "unaudited" on which we express no opinion, has been subjected to the auditing procedures



applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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

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

Schedule of Findings

Current Findings

Year ended June 30, 2007

None.

ILLINOIS STATE BOARD OF INVESTMENT
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Schedule of Findings

Prior Findings Not Repeated

Year ended June 30, 2007

Prior Findings Not Repeated – Government Auditing Standards:

Finding #07-1 – Inadequate Process for Valuation of Alternative Investments

The Illinois State Board of Investment (the Board) did not have an adequate established accounting and financial reporting process for determining the fair value measurements and disclosures, selecting appropriate valuation methods, and identifying and adequately supporting significant assumptions used for its alternative investments. (Finding Code No. 06-1)

Status of Corrective Action

The Board implemented comprehensive procedures for the monitoring and evaluation of alternative investments valuations.

Prior Findings Not Repeated – State Compliance:

Finding #07-2 – Inaccurate Allocation of Investment Earnings

The Board did not accurately allocate investment earnings to the General Assembly Retirement System, Judges' Retirement System of Illinois, and the State Employees' Retirement System of Illinois (member systems) during the year ended June 30, 2006. (Finding Code No. 06-2)

Status of Corrective Action

During our current year testwork, we noted the investment earnings were properly allocated.

Finding #07-3 – Deposit and Investment Custodial Credit Risk

The Board did not have a policy addressing deposit and investment custodial credit risk. (Finding Code No. 06-3, 05-1)

Status of Corrective Action

The Board adopted a policy addressing deposit and investment custodial credit risk.

ILLINOIS STATE BOARD OF INVESTMENT
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Supplementary Information for State Compliance Purposes

Year ended June 30, 2007

Summary

Supplementary Information for State Compliance Purposes presented in this section of the report includes the following:

Fiscal Schedules and Analysis:

- Comparative Schedule of Operations
- Schedule of Investment Portfolio
- Schedule of Investment Manager Fees
- Schedule of Soft Dollar Credits (Unaudited)
- Schedule of Investment Commissions (Unaudited)
- Schedule of Property and Equipment
- Reconciliation of the State Treasurer's Cash Balance with that of the Board
- Analysis of Accounts Receivables

Analysis of Operations:

- Board Functions and Planning Program
- Number of Employees
- Derivative Securities
- Securities Lending Program
- Proceeds from General Obligation Bonds, Pension Funding Series June 2003 (Unaudited)
- Legislative Changes
- Third-Party Marketing Fees Paid (Unaudited)
- Service Efforts and Accomplishments (Unaudited)

The accountants' report that covers the Supplementary Information for State Compliance Purposes presented in the Compliance Report Section states that it has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in the accountants' opinion, except for that portion marked "unaudited," on which they express no opinion, it is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

ILLINOIS STATE BOARD OF INVESTMENT
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Fiscal Schedules and Analysis

Comparative Schedule of Operations

Years ended June 30, 2007 and 2006

	2007	2006	Increase (decrease)
Investment income:			
Interest	\$ 172,400,021	183,047,403	(10,647,382)
Dividends	147,112,290	123,178,718	23,933,572
Securities lending	4,493,459	4,321,712	171,747
Realized gain on investments	848,635,310	775,805,644	72,829,666
Unrealized gain on investments	745,633,561	116,794,342	628,839,219
Total investment income	1,918,274,641	1,203,147,819	715,126,822
Expenses:			
Salaries and benefits	1,277,024	1,173,380	103,644
Operating	448,056	413,205	34,851
External support	38,838,254	28,556,047	10,282,207
Total expenses	40,563,334	30,142,632	10,420,702
Net investment income	\$ 1,877,711,307	1,173,005,187	704,706,120

ILLINOIS STATE BOARD OF INVESTMENT
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Fiscal Schedules and Analysis

Schedule of Investment Portfolio

June 30, 2007 and 2006

Fair value	2007		2006	
	Amount	Percentage of portfolio	Amount	Percentage of portfolio
Equities:				
Common stocks:				
U.S. equities:				
Consumer discretionary	\$ 750,423,267	5.86%	\$ 751,740,929	6.56%
Consumer staples	272,238,283	2.13	244,029,935	2.13
Energy	558,750,267	4.36	522,346,336	4.57
Financials	1,290,227,457	10.07	1,166,232,790	10.20
Healthcare	612,033,064	4.78	527,578,068	4.61
Industrials	817,691,924	6.39	788,874,178	6.90
Information Technology	860,066,637	6.72	723,628,007	6.33
Materials	250,548,688	1.96	173,292,349	1.52
Telecommunication Services	184,928,286	1.44	147,661,559	1.29
Utilities	144,204,447	1.13	137,675,225	1.20
Other	318,296,707	2.49	186,064,656	1.63
Non-U.S. equities	1,365,647,941	10.65	1,113,268,102	9.74
Preferred stock	1,865,020	0.01	1,057,334	0.01
Total equities	<u>7,426,921,988</u>	<u>57.99</u>	<u>6,483,449,468</u>	<u>56.69</u>
Fixed income securities:				
Government and agency obligations:				
U.S. Treasury	317,358,768	2.48	457,091,471	4.00
Federal agencies and other governments	867,031,944	6.77	651,309,629	5.70
Options	(114,828)	0.00	(169,563)	0.00
Municipal	—	0.00	2,688,451	0.02
Foreign obligations	72,189,687	0.56	104,455,671	0.91
Corporate obligations:				
Finance	256,092,972	2.00	306,124,824	2.68
Industrials	531,051,552	4.15	580,581,651	5.08
Commercial mortgage backed securities	57,603,793	0.45	60,372,208	0.53
Collateralized mortgage obligations	112,780,484	0.88	151,314,595	1.32
Asset-backed	87,801,215	0.69	143,583,472	1.26
Miscellaneous	154,338,401	1.21	96,553,993	0.84
Private placement	5,622,489	0.04	3,330,134	0.03
Commingled	23,679,106	0.18	40,713,286	0.36
Total fixed income securities	<u>2,485,435,583</u>	<u>19.41</u>	<u>2,597,949,822</u>	<u>22.73</u>
Real estate investments	1,189,614,911	9.29	1,134,025,154	9.92
Private equity	563,366,021	4.40	482,264,036	4.22
Infrastructure Funds	108,436,449	0.85	—	0.00
Hedge funds	496,404,578	3.88	416,462,183	3.64
Money market investments	535,699,912	4.18	320,641,552	2.80
Forward foreign currency contracts	(108,696)	0.00	26,145	0.00
Total investments	<u>\$ 12,805,770,746</u>	<u>100.00%</u>	<u>\$ 11,434,818,360</u>	<u>100.00%</u>

ILLINOIS STATE BOARD OF INVESTMENT
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Fiscal Schedules and Analysis

Schedule of Investment Manager Fees

Years ended June 30, 2007 and 2006

	<u>2007</u>	<u>2006</u>
Alinda	\$ 940,946	—
Amalgamated Bank NY	650,307	228,935
Ariel	152,973	454,835
Ativo	54,684	40,847
Atlanta Life	213,181	187,811
Bear Stearns and Company	—	161,697
Blackrock	848,243	851,895
Boston Company	1,295,327	211,663
Brandywine	866,896	339,710
Buford, Dixon	121,264	110,377
Capital Guardian	—	(183,804)
Channing	237,508	211,544
Chicago Equity Partners	260,090	204,720
Decatur	41,938	19,333
Earnest Partners	991,882	911,683
Fort Washington	584,037	545,888
Globeflex Capital	606,039	540,382
Goldman Sachs	1,536,224	1,455,907
Grosvenor Capital Management	1,017,417	490,863
Harris Investment Management	97,396	210,210
Harris Investment Management-High Yield	479,776	620,842
High Pointe	209,932	186,512
Holland Capital	—	696,521
Howland	118,088	76,832
IronBridge Capital Management	991,000	886,296
Ivy	1,267,457	772,607
JP Morgan Asset Management	2,876,435	—
LM Capital	266,692	204,420
Loomis Sayles	194,779	—
LSV Asset Management	2,161,689	1,893,042
Lynmar	285,785	157,314
Martingale Asset Management	1,279,997	1,112,479
Macquarie	2,700,624	—
Mesirow	1,021,165	529,444
New Amsterdam	896,395	888,674
NWQ	1,375,431	1,425,478
Opus Capital Management	288,492	244,053
Profit	288,074	155,335
Rhumblin	116,464	66,510
Rockcreek	1,268,194	551,779
Segall Bryant and Hamill	698,820	622,923
SSgA Bond Index Fund	—	13,134

ILLINOIS STATE BOARD OF INVESTMENT
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Fiscal Schedules and Analysis

Schedule of Investment Manager Fees

Years ended June 30, 2007 and 2006

	<u>2007</u>	<u>2006</u>
SSgA (Cash Overlay)	\$ 257,438	302,703
SSgA Intermediate Gov./Credit Index	64,894	77,408
SSgA Small Cap Global	1,609,981	1,908,733
SSgA Domestic Equity	—	50,323
Templeton	1,331,765	1,356,112
Trust Fund Advisors	543,348	661,740
UBS Global (formerly Brinson)	—	969,442
Union Labor Life Investment Co. (ULLICO)	729,960	700,295
Walter Scott	1,058,674	967,754
Western Asset Management	856,759	845,161
William Blair	1,542,910	1,496,142
	<u>\$ 37,297,370</u>	<u>27,434,504</u>

Investment manager fees are related to fees paid to various investment managers. Fees are negotiated primarily on market values and the manager's portfolio performance. A graduated rate is used for most managers based upon various increments per million dollars of market value.

ILLINOIS STATE BOARD OF INVESTMENT
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Fiscal Schedules and Analysis

Schedule of Soft Dollar Credits (Unaudited)

Years ended June 30, 2007 and 2006

	<u>2007</u>	<u>2006</u>
Soft dollar credits outstanding, at beginning of fiscal year	\$ 291,422	311,177
Soft dollar credits earned	44,089	27,249
Investment expenses paid with soft dollar credits	<u>(15,560)</u>	<u>(47,004)</u>
Soft dollar credits outstanding, at end of fiscal year	<u>\$ 319,951</u>	<u>291,422</u>

Soft dollar credits are issued to the Board by certain brokers based on the level of activity of investment managers using that particular broker. The Board can use these credits to pay for various investment expenses.

ILLINOIS STATE BOARD OF INVESTMENT
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Fiscal Schedules and Analysis

Schedule of Investment Commissions (Unaudited)

Years ended June 30, 2007 and 2006

	<u>2007</u>	<u>2006</u>
Investment brokerage firms:		
A. G. Edwards	\$ —	7,084
Abel Noser	9,100	—
Acento Securities	—	77,035
Allen & Company	—	7,682
Archipelago	16,845	39,402
Banc of America Securities Inc.	16,732	28,071
Bank of New York	18,932	59,971
BB&T Capital	6,981	—
Bear Stearns Securities Corp.	53,590	63,000
Berean Capital Inc.	40,229	72,648
Blair, William & Co.	9,317	45,580
Bloomberg Tradebook	19,421	23,193
BNY Brokerage	—	27,371
BNY ESI & Co.	8,306	15,149
BOE Securities	—	6,923
Cabrera Asset Management	116,514	105,779
Canaccord Adams Inc.	5,686	—
Cantor Fitzgerald & Co.	49,855	41,521
Capital Institutional Services Inc.	—	8,037
Capital Management Group	—	12,830
Cheevers & Company	68,870	40,793
CIBC World Markets Corp.	—	13,526
Citigroup Smith Barney Inc.	26,252	39,678
CJS Securities	—	13,530
Cowan & Company	—	6,455
Credit Suisse First Boston Corp.	35,419	50,964
Dain Rauscher	—	8,991
Deutsche Banc Securities Inc.	45,382	15,719
First Albany	—	11,744
First Honolulu	44,450	83,901
Flagstone	—	9,656
Fox Pitt Kelton	—	9,949
Friedman Billings and Ramsey & Co. Inc.	13,792	9,800
Garban International	—	5,872
Gardner Rich & Co.	145,018	81,672
Goldman Sachs & Company	33,299	25,165
Guzman & Co.	23,206	18,853
Hoenig & Co.	7,324	—
Instinet	8,826	12,262
International Strategy & Investment	11,782	—
Investment Technology Group	46,573	92,797
J.P. Morgan Securities, Inc.	36,508	20,064
Jackson Securities	24,010	—

ILLINOIS STATE BOARD OF INVESTMENT
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Fiscal Schedules and Analysis

Schedule of Investment Commissions (Unaudited)

Years ended June 30, 2007 and 2006

	<u>2007</u>	<u>2006</u>
Janney Montgomery Scott, Inc.	\$ 13,260	6,250
Jefferies & Company	38,536	33,692
Johnson Rice & Co.	10,461	—
Jones & Associates	5,413	38,150
Jones Trading	5,085	—
Keefe Bruynette and Woods Inc.	11,247	11,565
Legg Mason & Co.	—	15,984
Lehman Brothers Inc.	85,646	90,077
Liquidnet Inc.	202,404	142,311
Loop Capital Markets	132,511	139,807
Lynch Jones & Ryan	37,326	20,939
M. Ramsey King Securities	23,484	14,382
Magna Securities	23,876	20,910
McDonald and Company	—	5,554
Melvin Securities Corp	52,666	161,026
Merrill Lynch Pierce Fenner & Smith	56,389	43,833
Midwest Research Securities	10,076	11,605
Morgan Stanley & Co.	224,008	78,763
MR Beal	51,283	62,769
Muriel Siebert	22,350	5,009
Natexis Bleichroeder	10,925	—
Nomura Securities	5,861	—
Nutmeg Securities	42,224	40,006
NYFIX	15,815	—
Oppenheimer	—	14,882
Pacific American	18,454	13,190
Pipeline Trading Systems	11,250	—
Prudential Securities	12,982	14,896
Ramirez	5,970	12,296
Raymond James & Assoc.	12,174	10,764
Redi Book	15,048	—
Robert W. Baird & Co.	32,304	51,009
Robinson Humphery	21,049	5,897
Roth Capital	6,309	—
Salomon Smith Barney	36,374	12,523
Sanford C. Bernstein	18,864	42,907
Saxony	—	7,426
SBK Brooks	7,533	17,759
SG Cowen and Company	—	9,799
Sidoti	8,297	—
Smith Barney	—	5,012
State Street Bank	—	7,583
Stephen Inc.	14,081	7,133
Stiffel, Nicolaus & Company Inc.	9,773	—
Susquehanna Capital	—	12,579

ILLINOIS STATE BOARD OF INVESTMENT
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Fiscal Schedules and Analysis

Schedule of Investment Commissions (Unaudited)

Years ended June 30, 2007 and 2006

	<u>2007</u>	<u>2006</u>
Thomas Weisel Partners LLC	\$ —	8,613
Thompson Davis	7,789	7,553
U.S. Bancorp Piper Jaffray Inc.	7,046	13,677
UBS Securities	9,038	—
UBS Warburg Dillon Read	9,598	37,153
Wachovia Securities	—	8,919
Wedbush Morgan Securities, Inc.	8,116	13,925
Weeden & Co.	22,239	21,840
Wheat First	—	5,476
Williams Capital Group	109,452	101,521
Various (Under \$5,000)	187,836	157,980
	<u>\$ 2,614,641</u>	<u>2,777,611</u>

Commissions relate to fees paid to investment brokerage firms for the purchase and sale of investments.

ILLINOIS STATE BOARD OF INVESTMENT
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Fiscal Schedules and Analysis

Year ended June 30, 2007

Schedule of Property and Equipment

A schedule of changes in property and equipment is as follows:

	Beginning balance	Additions	Deletions	Ending balance
Cost	\$ 120,777	1,940	(22,181)	100,536
Less accumulated depreciation	(75,429)	(6,769)	30,945	(51,253)
Net property and equipment	\$ 45,348	(4,829)	8,764	49,283

Note: Amounts reported in the Schedule of Property and Equipment have been reconciled to property reports submitted to the Office of the Comptroller

Reconciliation of the State Treasurer's Cash Balance with that of the Board

Balance per State Treasurer at June 30, 2007	\$ 147,475
Vouchers in transit	(151,720)
Balance per Board at June 30, 2007	\$ (4,245)

Analysis of Accounts Receivable

The Board's receivable balance at June 30, 2007 amounted to \$548,269,714, which consisted of \$39,162,345 of dividends, interest, foreign taxes, and accounts receivable on investments held and receivables of \$509,107,369 for investments sold prior to June 30 but settled after year-end. Because the collection of this interest is relatively assured and the sale of investments is merely an issue of timing, the Board does not maintain a reserve for uncollectible receivables or age the receivable detail.

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Board Functions and Planning Program

The Illinois State Board of Investment (the Board) was created on October 10, 1969, by Article 22A of the Illinois Pension Code to manage and invest the assets and reserves of any pension fund or retirement system that transfers this responsibility to the Board. In accordance with Article 22A, the Trustees of the State Employees' Retirement System, the General Assembly Retirement System, and the Judges' Retirement System transferred all of their investment assets to the Board as of June 30, 1970. Since that date, all additional funds available for investment for those three systems have been transferred to the Board.

In 1978, in accordance with Article 24, the Board shall be responsible for developing and establishing the State Employees' Deferred Compensation Plan (the Plan). Initial enrollment began in 1979, at which time the Department of Personnel (now Department of Central Management Services) was named as the Administrator of the Plan. With respect to developing and establishing the plan, the Board reviews investment offering options for the Plan and supervises the Department of Central Management Services' administration of the Plan.

Beginning July 1, 1978, the Board merged the Illinois Board Fund, Illinois Equity Fund, and Illinois Segregated Fund into the Illinois State Board of Investment Commingled Fund (the Commingled Fund). The purpose of this consolidation was to enhance control over investment policy through increased flexibility in the allocation of cash reserves between fixed income and equity investments. The Board's investment policy and strategy can be more uniformly applied to each member system irrespective of cash flow. In addition, it simplified the Board's accounting and reporting systems. The result is that the Commingled Fund now represents all of the assets under the Board's supervision.

Beginning in 1982, the Board expanded the asset base of the Commingled Fund to include both real estate and venture capital.

In 1992, the Board completed its investment strategy to have all equity security investments managed externally.

During fiscal year 2004, the Board engaged Marquette Associates as its investment consultant. The Board conducted an asset allocation study and, in December 2003, adopted a written Asset Allocation Study. The Asset Allocation Study summarizes the Board's investment policies and measures of performance, formally documents objectives of the Board, and details a strategic plan for the Board. Criteria for the review and evaluation of investment managers are included in the Asset Allocation Study. Additionally, a methodology and format is outlined to highlight the results of the objectives and goals established within the Asset Allocation Study. The Asset Allocation Study reaffirms the broadly diversified investment strategy that has been pursued by the Board with the belief that, over a period of time, this approach will maximize investment return within a prudent level of risk.

Members of the board of directors as of June 30, 2007 include:

Guy W. Alongi
James Buchanan
Allison S. Davis
Michael Goetz
Ronald E. Powell

Treasurer Alexi Giannoulis
Justice Thomas E. Hoffman
Gordon John Mazzotti
Representative Kurt M. Granberg

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The Board has established both long-term and short-term goals with the intention of maximizing earnings for Member Retirement Systems' investments. These goals are reviewed in accordance with the Strategic Investment Policy.

Number of Employees

The Board had 9 full-time employees at June 30, 2007 and 11 full-time employees at June 30, 2006.

Derivative Securities

Some of the Board'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. The Board'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. 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. 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 of trustees 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 (CMOs), futures, and options. The remaining derivative securities are used to improve the yields or to hedge changes in interest rates.

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Forward foreign currency contracts are used to hedge against the currency risk in the Board'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 market values of the forward contracts vary, 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 market values 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)
			\$ 26,145

The Board 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.

The Board's 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 futures 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 market values of the future 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, the Board 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, the Board 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.

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The following table shows the futures and options positions held by the Board as of June 30, 2007 and 2006:

	<u>2007</u>		<u>2006</u>	
	<u>Number of contracts</u>	<u>Contract principal</u>	<u>Number of contracts</u>	<u>Contract principal</u>
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	—	—	23,550,000	23,550,000
Fixed income purchased put options	—	—	58	58,000,000
Fixed income purchased call options	241	241,000,000	—	—

Securities Lending Program

The Board participates in a securities lending program with State Street Bank and Trust 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 market 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 the Board with counterparty default indemnification. The Board had no credit risk as a result of its securities lending program as the collateral held exceeded the market value of the securities lent. As of June 30, 2007 and 2006, there were outstanding loaned investment securities having market values of \$2,129,513,426 and \$1,568,683,721, respectively, against which collateral was received with a 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 the Board does not have the ability to pledge or sell.

Proceeds from General Obligation Bonds, Pension Funding Series June 2003 (Unaudited)

Public Act 93-0002 (the Act) became effective on April 7, 2003 and authorized the State of Illinois to issue \$10 billion of General Obligation Bonds for the purpose of making contributions to designated retirement systems. The State Employees' Retirement System, General Assembly Retirement System, and Judges' Retirement System are "designated retirement systems" for the purpose of this Act.

On June 12, 2003, the State of Illinois issued \$10 billion of General Obligation Bonds, Pension Funding Series June 2003. 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 \$1,544,924,744 on July 1, 2003. The monies were deposited into the Master Trust Account with the Illinois State Board of Investment, on July 2, 2003. The Board initially approved investing the pension bond proceeds in separate index funds. These index funds were

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subsequently liquidated and combined with the Board's other investments and invested in accordance with the asset allocation policy of the Board during the year ended June 30, 2004. The Board estimates the return of the pension bond proceeds earned an annual rate of return of 17.1% during the year ended June 30, 2007, which is the same as the overall return for the Board's investment portfolio.

Legislative Changes

On June 1, 2005, Public Act 94-0004 was enacted addressing the early retirement option, benefit changes and funding reductions to the retirement systems. The legislation included a funding reduction of approximately \$429.4 million in fiscal year 2007, for employer contributions to the State Employees', Judges' and General Assembly Retirement Systems. This funding resulted in member systems' withdrawals of \$642 million in fiscal year 2007 to meet their respective funding requirements for benefit obligations.

Third-Party Marketing Fees Paid (Unaudited)

The Board disclosed that investment managers hired marketing groups to assist with promoting their investment product to the Board. Marketing fees paid by investment managers were as follows:

<u>Investment Manager</u>	<u>Third Party Marketer</u>	<u>Type of Fund</u>	<u>Year ended June 30</u>	
			<u>2007</u>	<u>2006</u>
Alinda Infrastructure Fund	C.P. Eaton & Associates	Infrastructure	\$ 399,614	—
Blackstone Capital Ptrs.V	Park Hill Group	Private Equity	175,000	—
Castile Ventures	Connors & Co.	Private Equity	75,000	—
Court Square Capital Partners II	UBS P.E. Funds Group	Private Equity	229,625	—
Harris Bank	Michael Dudek	Fixed Income	—	56,578
Howland & Associates	Carol Mackoff	Equity	—	7,923
Ironbridge Capital	Frontier Partners-Frontegra Asset Mgmt.	Equity	198,337	177,259
Ivy Asset Management	The Marwood Group	Hedge Fund	301,939	183,954
William Blair	Orlando Jones	Equity	176,395	211,408
Total			<u>\$ 1,555,910</u>	<u>637,122</u>

Service Efforts and Accomplishments (Unaudited)

For purposes of evaluating service efforts and accomplishments, three different measures have been included. One measure presents a historical perspective of overall annual and compound rates of return; another compares benchmark rates of return with actual rates of return by fund; and the last presents asset allocations by fund type.

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Overall Rates of Return

	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>
Annual total return	17.1%	11.0%	10.1%	16.4%	0.3%
Compound annual rate of return since July 1, 1982	11.5	10.7	10.7	10.8	10.5

Investment Returns – Benchmark and Actual

The Board operates under a long-range investment plan with the objective to maximize the total rate of return. The objectives set forth are as follows:

- At least equal to the assumed actuarial interest rate, currently 8.5% per year
- At least equal to the return of a composite benchmark of market indices in the same proportions as the Board's asset allocation policy targets

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The Board earned a total rate of return of 17.1% for the year ended June 30, 2007, which met the investment objectives.

	<u>2007</u>	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>(Annualized)</u>	
						<u>3 years</u>	<u>5 years</u>
Total fund	17.1%	11.0%	10.1%	16.4%	0.3%	12.6%	10.8%
<i>Composite bench mark*</i>	16.4	11.5	10.9	16.3	3.5	13.0	11.7
<i>Consumer price index</i>	2.7	4.2	2.5	3.3	2.1	3.2	3.0
U.S. equities	19.9	10.7	9.3	21.7	0.9	13.1	11.8
<i>Wilshire 500 Index</i>	20.4	10.0	8.4	21.2	1.3	12.8	12.0
International equities	28.8	28.9	14.8	29.8	(7.5)	24.0	17.9
<i>MSCI-EAFE Index</i>	27.5	27.1	14.1	32.9	(6.1)	22.8	18.2
Fixed income	6.9	0.8	6.9	0.7	8.3	4.8	4.7
<i>Lehman U.S. Universal Bond Index</i>	6.6	(0.3)	7.4	1.0	11.5	4.5	5.2
Real estate	15.3	19.5	14.8	9.1	2.2	16.5	12.0
<i>NCRIF Real Estate Index</i>	17.2	18.7	15.6	9.7	5.2	18.0	14.4
Private equity	31.7	21.3	29.6	16.9	(4.9)	27.5	17.2

* Composite benchmark:

Effective 12/2003: 45% Wilshire 5000; 10% MSCI-EAFE; 25% Lehman Universal; 10% NCRIF; 5% Venture Economic all Private Equity Index; 5% HFR Equity Hedged Index.

Effective 04/2002: 46% Russell 3000; 15% MS-AC Free ex U.S.; 23% Lehman Universal; 8% NCRIF; 8% Russell 2000 +3.0%.

Prior to 04/2002: 43% Russell 3000; 20% MS-AC Free ex U.S.; 22% Lehman Aggregate; 7% NCRIF; 8% absolute return of 12%.

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Net Asset Allocations as of June 30, 2007

The investment policy of the Board establishes asset allocation targets and ranges for each asset class, selected to accomplish the long-range investment plan. The actual asset mix is roughly in line with the policy target, with modest over-allocations to U.S. equity and unallocated cash with offsetting under-allocations to international equity, alternative investments, and real estate.

	Fair value	Actual asset mix	Policy target
	(Dollars in millions)		
U.S. equity	\$ 6,061.3	48%	45%
U.S. equity hedge funds	496.4	4	5
International equity	1,365.7	11	10
Fixed income ¹	2,485.4	20	20
Real estate	1,189.6	10	10
Private Equity ²	563.4	4	5
Infrastructure ²	108.4	1	5
Cash ³	282.0	2	—
Total	\$ 12,552.2	100%	100%

¹ Maturities of one year or longer, including convertible bonds.

² Interests in limited partnerships and other entities which have limited liquidity.

³ Includes money market instruments and other assets, less liabilities.