# ILLINOIS STATE BOARD OF INVESTMENT

An Internal Investment Pool of the State of Illinois

Financial Statements
June 30, 2011
(With Independent Auditors' Report Thereon)
Performed as Special Assistant Auditors
for the Auditor General, State of Illinois

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

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**ILLINOIS STATE BOARD OF INVESTMENT**
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**Financial Statement Report**

**Summary**


The audits of the accompanying financial statements of the Illinois State Board of Investment (ISBI) were performed by McGladrey & Pullen, LLP.

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

McGladrey

## Independent Auditors' Report

Honorable William G. Holland
Auditor General
State of Illinois

Board of Trustees
Illinois State Board of Investment:

As Special Assistant Auditors for the Auditor General, we have audited the accompanying Statements of Net Assets of the Illinois State Board of Investment (ISBI), an internal investment pool of the State of Illinois, as of June 30, 2011 and June 30, 2010, and the related Statements of Changes in Net Assets for the years then ended, as listed in the table of contents. These financial statements are the responsibility of the ISBI's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets of the ISBI as of June 30, 2011 and June 30, 2010, and the changes in net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 6 to the financial statements, the fair value of the investment portfolio as of June 30, 2011 has experienced a decline due to unfavorable market conditions that have occurred subsequent to June 30, 2011. The information presented in Note 6 has not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on it.

In accordance with *Government Auditing Standards*, we have also issued our report dated December 14, 2011 on our consideration of the ISBI's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audits.

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

McGladrey & Pullen, LLP

Schaumburg, Illinois
December 14, 2011

# 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). 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, 2011 and 2010.

## Financial Highlights

The net assets of ISBI totaled approximately $11.5 billion at fiscal year end June 30, 2011. The increase from the previous year is primarily the result of receiving $746 million in new funding as well as investment gains.

## General Market Risk

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

## Overview of the Financial Statements

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

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

The gain in investments at June 30, 2011 is a result of an investment gain of 21.7% for the fiscal year, net of expenses which are shown in the Statements of Changes in Net Assets. The decrease in liabilities for fiscal 2011 compared with 2010 consisted mainly of a decrease in unsettled investment purchases as well as a decrease in the securities lending cash collateral obligation. This decrease in the securities lending obligation is a result of ISBI's decision to reduce its risk to the credit markets as a result of the securities lending program. ISBI's securities lending program now focuses on intrinsic value lending rather than collateral investment return and emphasizes lending quality rather than loan quantity.

The Statements of Changes in Net Assets presents information regarding changes during the fiscal year ended June 30, 2011. 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 Assets

| | June 30 | | | 2011/2010 | 2010/2009 |
|---|---|---|---|---|---|
| | 2011 | 2010 | 2009 | Change | Change |
| | $ | $ | $ | $ | $ |
| Cash | 12,344,783 | 3,594,060 | 12,662,039 | 8,750,723 | (9,067,979) |
| Receivables | 66,419,100 | 68,431,963 | 186,099,275 | (2,012,863) | (117,667,312) |
| Investments | 11,498,251,354 | 9,665,737,091 | 8,735,057,063 | 1,832,514,263 | 930,680,028 |
| Securities lending collateral | 211,162,204 | 997,638,887 | 1,395,768,802 | (786,476,683) | (398,129,915) |
| Prepaid Expenses | 7,013 | 21,269 | 16,184 | (14,256) | 5,085 |
| Capital Assets | 36,348 | 50,391 | 57,635 | (14,043) | (7,244) |
| Total assets | 11,788,220,802 | 10,735,473,661 | 10,329,660,998 | 1,052,747,141 | 405,812,663 |
| Liabilities | 260,595,778 | 1,056,769,859 | 1,645,606,726 | (796,174,081) | (588,836,867) |
| Total net assets | 11,527,625,024 | 9,678,703,802 | 8,684,054,272 | 1,848,921,222 | 994,649,530 |

# Management's Discussion and Analysis

The net investment gains for the year ended June 30, 2011 were the result of upward movement in the securities markets. There was an increase in withdrawals by the member systems. Fiscal year 2011 withdrawals were $941.8 million compared with $661.0 million in fiscal year 2010. Withdrawals are determined by the member retirement systems based on the State's funding and the Member Systems' benefit payment needs. As a result of increasing benefit payment needs withdrawals increased for the year. The decrease in administrative expenses for fiscal year 2011 compared to 2010 was accomplished by consolidating job responsibilities that resulted in an unfilled open position and a decrease in investment management fees due to the renegotiation on fees with various investment managers and the decrease in the number of investment managers retained.

The net investment gains for the year ended June 30, 2010 were the result of an upward movement in the securities markets. The increase in assets for fiscal 2010 compared with 2009 consisted mainly of an increase in investments from the investment of proceeds from bonds issued by the State of Illinois and reinvested investment gains. The decrease in liabilities for fiscal 2010 compared with 2009 consisted mainly of a decrease in securities lending collateral obligations and a decrease in unsettled investment purchases.

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

### Condensed Statements of Changes in Net Assets

| | Fiscal Years Ended June 30 | | | 2011/2010 | 2010/2009 |
|---|---|---|---|---|---|
| | 2011 | 2010 | 2009 | Change | Change |
| | $ | $ | $ | $ | $ |
| Additions: | | | | | |
| Net investment income (loss) | 2,082,398,245 | 883,932,935 | (2,312,726,206) | 1,198,465,310 | 3,196,659,141 |
| Contributions from the State of Illinois | 745,546,496 | 809,401,372 | | (63,854,876) | 809,401,372 |
| Total additions | 2,827,944,741 | 1,693,334,307 | (2,312,726,206) | 1,134,610,434 | 4,006,060,513 |
| Deductions: | | | | | |
| Member Systems' withdrawals | 941,800,000 | 661,000,000 | 277,000,000 | 280,000,000 | 384,000,000 |
| Administrative expenses | 37,223,519 | 37,684,777 | 41,272,683 | (461,258) | (3,587,906) |
| Total deductions | 979,023,519 | 698,684,777 | 318,272,683 | 280,338,742 | 380,412,094 |
| Net increase (decrease) in net assets | 1,848,921,222 | 994,649,530 | (2,630,998,889) | 854,271,692 | 3,625,648,419 |

### Future Outlook

One of the more meaningful events for the portfolio in 2011 was a change in the actuarially assumed rate of return. Historically SERS had adopted 8.5% as the actuarially assumed rate of return, while the GARS and the JRS has assumed 8.0%. In September of 2010 SERS reduced its return assumption from 8.5% to 7.75%. Similarly, the GARS and JRS reduced their return assumptions from 8.0% to 7.0%. As a result of these adjustments to the assumed rates of return, and due to the fact it had been three years since an asset allocation study had been performed, the Board directed its consultant, Marquette Associates, to perform a new asset allocation study. At its June 2011, meeting the Board amended its asset allocation policy, incorporating recommendations made by Marquette Associates to be implemented in Fiscal 2012.

While no changes were made related to general asset allocation, changes were made within the respective asset classes. In particular:

- Domestic Equity: Portfolio weightings were shifted away from large cap stocks toward mid cap and small cap stocks; reliance on active management was diminished in favor of passive management; and exposure was shifted away from growth to value.
- International Equity: 5% of the portfolio was allocated to a passively managed emerging market strategy.
- Fixed Income: Exposure to commercial real estate debt was reduced, while exposure to bank loans and high yield debt was increased. The Board also made a 3% allocation to non-US bonds.
- Real Estate: Emphasis on core real estate was increased, with the establishment of a target of 80% core real estate and 20% non-core real estate.
- Infrastructure/Real Assets: ISBI's infrastructure allocation was re-labeled Real Assets, with a 5% target.
- Private Equity: No changes were made to the private equity portfolio.

# Statements of Net Assets

JUNE 30, 2011

| | 2011 | 2010 |
|---|---|---|
| | $ | $ |
| ASSETS | | |
| Cash | 12,344,783 | 3,594,060 |
| Receivables: | | |
| Foreign taxes | 2,732,489 | 3,603,072 |
| Accounts receivable | 3,165,120 | 516,790 |
| Investments sold | 25,152,183 | 35,345,547 |
| Interest and dividends | 35,369,308 | 28,966,554 |
| Total receivables | 66,419,100 | 68,431,963 |
| Prepaid expenses | 7,013 | 21,269 |
| Capital assets | 36,348 | 50,391 |
| Investments at fair value: | | |
| U.S. Government and agency obligations | 1,367,098,751 | 810,739,312 |
| Foreign government obligations | 37,951,769 | 44,409,906 |
| Corporate obligations | 762,833,382 | 925,668,388 |
| Domestic common stock and equity funds | 3,380,198,858 | 2,857,144,559 |
| Commingled funds | 256,817,374 | 270,510,642 |
| Preferred stock | 0 | 517,676 |
| Foreign equity securities | 2,195,201,185 | 1,733,177,670 |
| Foreign preferred stock | 40,032 | 179,924 |
| Hedge funds | 1,075,584,754 | 917,854,201 |
| Real estate funds | 819,053,366 | 750,210,957 |
| Private equity | 629,256,286 | 542,441,291 |
| Money market instruments | 303,501,465 | 270,231,935 |
| Infrastructure funds | 417,267,415 | 320,293,041 |
| Bank loans | 253,447,070 | 222,623,999 |
| Foreign currency forward contracts | (353) | (266,410) |
| Total investments | 11,498,251,354 | 9,665,737,091 |
| Securities lending collateral | 211,162,204 | 997,638,887 |
| Total assets | 11,788,220,802 | 10,735,473,661 |
| LIABILITIES | | |
| Payables: | | |
| Investments purchased | 36,930,925 | 40,837,912 |
| Administrative expenses | 6,947,640 | 5,816,888 |
| Securities lending cash collateral obligation | 216,717,213 | 1,010,115,059 |
| Total liabilities | 260,595,778 | 1,056,769,859 |
| Net assets | 11,527,625,024 | 9,678,703,802 |

See notes to financial statements, pages 8-20

# Statements of Changes in Net Assets

JUNE 30, 2011

| | 2011 | 2010 |
|---|---|---|
| | $ | $ |
| ADDITIONS | | |
| Investment income: | | |
| Net increase in fair value of investments | 1,810,488,419 | 634,013,226 |
| Interest and other | 136,079,683 | 128,588,561 |
| Dividends | 132,335,702 | 114,725,819 |
| Securities lending income | 2,900,006 | 6,125,355 |
| Securities lending rebates | 968,335 | 1,206,593 |
| Securities lending expenses | (373,900) | (726,619) |
| Total investment income | 2,082,398,245 | 883,932,935 |
| Contributions from the State of Illinois | 745,546,496 | 809,401,372 |
| Total additions | 2,827,944,741 | 1,693,334,307 |
| DEDUCTIONS | | |
| Administrative expenses: | | |
| Salaries and benefits: | | |
| Salaries | 1,182,265 | 1,366,941 |
| Benefits | 595,733 | 579,934 |
| Operating expenses: | | |
| Rent and utilities | 171,595 | 164,672 |
| Audit | 151,830 | 151,830 |
| Other | 192,109 | 210,664 |
| External support: | | |
| Custody | 218,026 | 251,248 |
| Consulting and professional | 1,236,508 | 1,270,019 |
| Investment advisors/managers | 33,319,362 | 33,540,400 |
| Investment services and research | 156,091 | 149,069 |
| Total administrative expenses | 37,223,519 | 37,684,777 |
| Member Systems' withdrawals | 941,800,000 | 661,000,000 |
| Total deductions | 979,023,519 | 698,684,777 |
| Increase in net assets | 1,848,921,222 | 994,649,530 |
| Net assets at beginning of year | 9,678,703,802 | 8,684,054,272 |
| Net assets at end of year | 11,527,625,024 | 9,678,703,802 |

See notes to financial statements, pages 8-20

## *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.

The assets of the Member Systems are accounted for in a single commingled fund. Separate information on each System's participation is presented in Note 3.

### Basis of Accounting
Accounting records are maintained on an accrual basis. Units are allocated monthly to each Member System 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 Government and Corporate Obligations, Convertible Bonds – prices quoted by a major dealer in such securities; (2) Common Stock and Equity Funds, Preferred Stock, Foreign Equity Securities, Forward Foreign Currency Contracts and Options: (a) Listed – closing prices as reported on the composite summary of national securities exchanges; (b) Over-the-counter – bid prices; (3) Money Market Instruments – average cost which approximates fair values; (4) Real Estate Investments – fair values as determined by ISBI and its investment managers; (5) Alternative Investments (Private Equity, Hedge funds, Bank Loans and Infrastructure funds) – fair values as determined by ISBI and its investment managers; (6) Commingled funds – fair values as determined by ISBI and its investment managers.

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

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

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

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

### Risk Management
ISBI, as part of the State, provides for risks of loss associated with workers' compensation and general liability through the State's self-insurance program. 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 ISBI's net assets.

### 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.

### Reclassification

Certain items in the 2010 financial statements have been reclassified to conform to the 2011 presentation.

### Compensated Absences

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

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

### Subsequent Events

ISBI has evaluated subsequent events for potential recognition and/or disclosure through December 14, 2011, the date the financial statements were available to be issued.

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

### Deposits
Custodial credit risk for deposits is the risk that, in the event of a financial institution failure, ISBI's deposits may not be returned. All non-investment related bank balances at year-end are insured or collateralized with securities held by the Illinois State Treasurer or agents in the name of the State Treasurer. As of June 30, 2011 and 2010, ISBI had non-investment related bank balances of $119,804 and $34,557, respectively. During fiscal year 2007, a Credit Risk Policy was implemented by ISBI staff and formally adopted by ISBI in July of 2007. The Policy outlines the control procedures used to monitor custodial credit risk. These assets are under the custody of State Street Bank and Trust Company. State Street Bank and Trust Company has an AA- Long-term Deposit/Debt rating by Standards & Poor and an Aa2 rating by Moody. Certain investments of ISBI with maturities of 90 days or less would be considered cash equivalents; these consist of short-term investment funds and U.S. Treasury bills with maturities of 90 days or less, which are not subject to the custodial credit risk. For financial statement presentation and investment purposes, ISBI reports these types of cash equivalents as Money Market Instruments in the Statements of Net Assets. As of June 30, 2011 and 2010, ISBI had investment related bank balances of $12,234,333 and $3,630,043, respectively. These balances include USD and foreign cash balances. The USD cash balances had no exposure to custodial credit risk as a result of the passage of the Dodd Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank Act") in July 2010, the FDIC must provide unlimited deposit insurance coverage for balances held in US dollar non-interest bearing transaction accounts (DDAs) for a period of two years, beginning on December 31, 2010 and ending on December 31, 2012. At any given point and time, the foreign cash balances may be exposed to custodial credit risk.

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

As described in Note 1, ISBI currently manages and invests the assets of the Member Systems. 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
Real Estate and Private Equity investment portfolios consist of passive interests in limited partnerships. ISBI had outstanding commitments to these limited partnerships of approximately $344 million and $463 million as of June 30, 2011 and 2010, respectively. At the end of fiscal year 2011 and 2010, ISBI had outstanding commitments of $321 million and $154 million to separate real estate accounts, respectively. Also at the end of fiscal year 2011 and 2010, ISBI had outstanding amounts of $102 million and $147 million to infrastructure funds, respectively. ISBI would 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 infrastructure funds 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.

### 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.

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

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

Investment strategies of Real Estate investments include, but are not limited to, the purchase, development, ownership, management, rental and/or sale of real estate for profit. In May 2011, RLJ Lodging Fund II a limited partnership investment was exchanged by ISBI for 1,035,092 shares of restricted common stock as a result of an initial public offering (IPO) transaction conducted by RLJ Lodging Trust. Due to the fact that this holding is currently restricted for sale as a result of a lock-up agreement in place that specifies that during the period that commences 180 days from the date of the initial IPO the holders of the shares will not without prior written consent of the underwriting group directly or indirectly offer, pledge, sell, contract to sell, sell any option or contract to purchase, purchase any option or contract to sell, grant any option, right or warrant for sale of, or otherwise dispose or transfer such shares. As of June 30, 2011, this holding is an illiquid asset as a result of this restriction. The fair value of these shares at June 30, 2011 is $17,959,548. As a result of the current illiquidity of this investment, ISBI has determined that it is appropriate to continue to classify the asset as a real estate investment. When the restrictions imposed by the lock-up agreement lapse ISBI will reclassify the investment as common stock.

ISBI's investments in infrastructure funds represent pooled investment vehicles used to seek capital appreciation and current income by acquiring, holding, financing, refinancing and disposing of infrastructure investments and related assets. Infrastructure 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 not have any single issuer investment that exceeded 5% of the total net assets of ISBI as of June 30, 2011 and 2010. The following table presents the quality ratings of debt securities held by ISBI as of June 30, 2011 and 2010:

| | Moody's Quality Rating | 2011 | 2010 |
|---|---|---|---|
| | | $ | $ |
| U.S. Government and agency obligations | AAA | 1,355,098,991 | 785,753,044 |
| | A | - | 11,999,760 |
| | Not rated | 11,999,760 | 12,986,508 |
| Total U.S. Government and agency obligations | | 1,367,098,751 | 810,739,312 |
| Foreign government obligations | AA | 2,972,737 | 1,601,595 |
| | A | 9,187,174 | 13,951,076 |
| | BAA | - | 10,708,205 |
| | BA | 7,107,320 | 11,475,920 |
| | B | 17,263,610 | 5,659,170 |
| | Not rated | 1,420,928 | 1,013,940 |
| Total foreign government obligations | | 37,951,769 | 44,409,906 |
| Corporate obligations | AAA | 17,786,171 | 43,798,021 |
| | AA | 87,458,769 | 78,359,254 |
| | A | 193,686,773 | 272,476,793 |
| | BAA | 99,755,613 | 201,122,004 |
| | BA | 84,923,049 | 85,333,142 |
| | B | 243,240,592 | 188,825,884 |
| | CAA | 11,141,685 | 38,250,212 |
| | Not rated | 24,840,730 | 17,503,078 |
| Total corporate obligations | | 762,833,382 | 925,668,388 |

*Note 2 (continued)*
*Deposits, Investments, and Investment Risk*

### 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, 2011 and 2010, there were no investments that were uninsured and unregistered, securities held by the counterparty or by its trust department or agent but not in ISBI's name.

### Interest Rate Risk

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

Duration is the measure of a debt investment's exposure to fair value changes arising from changing interest rates. It uses the present value of cash flows, weighted for those cash flows as a percentage of the investment's fair value. The effective duration measures the sensitivity of market price to parallel shifts in the yield curve. As of June 30, 2011 and 2010, ISBI benchmarked its debt security portfolio to Barclay's Capital Intermediate U.S. Government/Credit Bond Index. At June 30, 2011 and 2010, the effective duration of the Barclay's Capital Intermediate U.S. Government/Credit Bond Index was 3.9 years. At the same point in time, the effective duration of the ISBI debt security portfolio at June 30, 2011 and 2010 was 4.6 and 3.8 years, respectively. Below is the detail of the duration by investment type as of June 30, 2011 and 2010:

| | 2011 | | 2010 | |
|---|---|---|---|---|
| | Fair Value | Effective Weighted Duration | Fair Value | Effective Weighted Duration |
| Investment Type | $ | Years | $ | Years |
| U.S. Government and Agency Obligations | | | | |
| U.S. Government | 479,422,631 | 6.9 | 155,303,411 | 4.8 |
| Agency | 887,676,120 | 3.6 | 655,435,901 | 2.3 |
| Foreign Government Obligations | 37,951,769 | 4.3 | 44,409,906 | 4.9 |
| Corporate Obligations | | | | |
| Bank and Finance | 204,608,577 | 4.2 | 246,087,134 | 4.8 |
| Collateralized Mortgage Obligations | 13,492,526 | 2.1 | 39,240,826 | 3.0 |
| Industrials | 425,847,041 | 4.4 | 496,856,383 | 4.8 |
| Other | 118,885,238 | 4.2 | 143,484,045 | 5.0 |
| | 2,167,883,902 | | 1,780,817,606 | |

### 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 $50,878,191 and $34,896,279 as of June 30, 2011 and 2010, respectively. The following are the amounts of foreign investments by the currency in which they are denominated as of June 30, 2011 and 2010:

### Securities Lending

ISBI participates in a securities lending program with Credit Suisse AG, New York Branch who acts as securities lending agent. Securities are loaned to brokers and, in return, ISBI receives cash and non-cash collateral. All of the securities are eligible for the securities lending program. Collateral consists solely of cash and U.S. government securities having a fair value equal to or exceeding 102% of the value of the loaned securities (105% for non-

| | 2011 | | 2010 | |
|---|---|---|---|---|
| Currency | Foreign Equity Securities and Foreign Preferred Securities | Foreign Government Obligations | Foreign Equity Securities and Foreign Preferred Securities | Foreign Government Obligations |
| | $ | $ | $ | $ |
| Australian Dollar | 109,809,451 | - | 80,124,165 | - |
| Brazilian Real | 62,981,703 | - | 52,217,836 | - |
| Canadian Dollar | 144,335,493 | - | 97,585,461 | - |
| Danish Krone | 25,279,264 | - | 29,767,544 | - |
| Egyptian Pound | 1,549,693 | - | 2,121,276 | - |
| English Pound Sterling | 388,163,730 | - | 333,465,799 | - |
| Euro | 550,189,912 | - | 401,821,017 | - |
| Hong Kong Dollar | 83,691,016 | - | 60,278,477 | - |
| Hungarian Forint | 1,711,349 | - | 266,743 | - |
| Indonesian Rupian | 1,735,957 | - | 992,274 | - |
| Israeli Shekel | 4,293,903 | - | - | - |
| Japanese Yen | 249,633,309 | - | 222,916,572 | - |
| Mexican Peso | 10,577,337 | - | 5,584,047 | - |
| New Zealand Dollar | 4,812,384 | - | 3,181,046 | - |
| Norwegian Krone | 25,479,679 | - | 15,111,055 | - |
| Singapore Dollar | 51,977,284 | - | 35,452,297 | - |
| South African Rand | 11,571,713 | - | 8,691,759 | - |
| South Korean Won | 62,696,222 | - | 39,303,338 | - |
| Swedish Krona | 35,264,901 | - | 21,927,042 | - |
| Swiss Franc | 154,181,296 | - | 121,970,148 | - |
| Thailand Baht | - | - | 1,081,519 | - |
| Foreign Investments denominated in U.S. dollars | 215,305,621 | 37,951,769 | 199,498,179 | 44,409,906 |
| | 2,195,241,217 | 37,951,769 | 1,733,357,594 | 44,409,906 |

***Note 2 (continued)***
***Deposits, Investments, and Investment Risk***

U.S. securities). In the event of borrower default, Credit Suisse AG, New York Branch provides ISBI with counterparty default indemnification. Investments in the cash collateral account represent securities that were distributed to ISBI in connection with the in-kind redemption of ISBI's ownership in the State Street Bank and Trust Company Quality Funds for Short-Term Investment ("Quality D"). Credit Suisse is not responsible for any losses with regards to these legacy investments. This arrangement subjects ISBI to credit risk as the credit quality of these investments may decline over time. The credit risk on the legacy investments is the risk of a possible loss arising from the inability of a counterparty to meet its obligations. These losses 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 is returned to them. As of June 30, 2011 and 2010, respectively, the collateral received exceeded the fair value of the securities loaned. As of June 30, 2011 and 2010, there were outstanding loaned investment securities having fair values of $221,448,333 and $1,055,476,733, respectively; against which collateral was received with a fair value of $230,083,146 and $1,091,589,381, respectively. Collateral received at June 30, 2011 and 2010 consisted of $216,717,213 and $1,010,115,059, respectively, in cash and $13,987,903 and $81,474,322, respectively, in securities for which ISBI does not have the ability to pledge or sell.

The cash collateral received is invested in a short term investment pool having a fair value of $211,162,204 and $997,638,887 as of June 30, 2011 and 2010, respectively. This investment pool had an average duration of 31.18 days and 12.45 days as of June 30, 2011 and 2010, respectively. Any decrease in the fair value of invested cash collateral is recorded as unrealized losses and reported as a component of the investment income/loss on the Statements of Changes in Net Assets.

***Derivative Securities***

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

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

In May 2011, ISBI removed language from the investment management agreements allowing managers to hedge foreign currencies and/or to hedge equity positions.

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). A financial futures contract is an agreement to buy or sell a specific amount at a specified delivery or maturity date for an agreed-upon price. The fair values of the futures contract vary from the original contract price, a gain or loss is recognized and paid to or received from the clearinghouse. The gain or loss is recognized in the net increase/decrease in the fair value of investments in the Statements of Change in Net Assets. Financial futures represent an off-balance sheet obligation, as there are no balance sheet assets or liabilities associated with those contracts other than the fair values. The cash or securities to meet these obligations are held in the investment portfolio.

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

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.

The following table presents the investment derivative instruments aggregated by type that were held by ISBI as of June 30, 2011 and 2010:

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. 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

| | Changes in Fair Value | | Fair Value at Year End | | Notional Amount | |
|---|---|---|---|---|---|---|
| | 2011 | 2010 | 2011 | 2010 | 2011 | 2010 |
| | $ | $ | $ | $ | Number of Shares | Number of Shares |
| FX Forwards | (15,460,385) | 4,751,552 | (353) | (266,410) | N/A | N/A |
| Futures | N/A | N/A | N/A | N/A | 65,250 | 51,300 |
| Rights | 840,746 | 1,184,339 | 162,133 | 227,807 | 901,548 | 905,044 |
| Warrants | 16,898,459 | 12,100,555 | 66,421,545 | 65,373,110 | 5,272,322 | 3,391,468 |
| | 2,278,820 | 18,036,446 | 66,583,325 | 65,334,507 | 6,239,120 | 4,347,812 |

The table below shows the futures positions held by ISBI as of June 30, 2011 and 2010.

| | 2011 | | 2010 | |
|---|---|---|---|---|
| | Number of Contracts | Contract Principal* | Number of Contracts | Contract Principal* |
| | | $ | | $ |
| Equity futures purchased | 1,305 | 85,836,375 | 1,026 | 52,664,580 |

*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 Assets.

***Note 2 (continued)***
***Deposits, Investments, and Investment Risk***

the risk positions of the investment managers are reviewed on a periodic basis to monitor compliance with the limits. As of June 30, 2011 and June 30, 2010, ISBI held no derivatives subject to interest rate risk. The ISBI has not adopted a formal policy specific to master netting arrangements.

ISBI's derivative investments in foreign currency forward contracts are held with counterparties. The credit ratings and net exposure as of June 30, 2011 and 2010 for the counterparties are as follows:

| | 2011 | | | 2010 | | |
|---|---|---|---|---|---|---|
| Moody's Rating* | Fair Value | Net Exposure | Percentage of Net Exposure | Fair Value | Net Exposure | Percentage of Net Exposure |
| | $ | $ | % | $ | $ | % |
| Aa3 | 188 | 188 | 0.01 | - | - | - |
| A3 | 2,736,018 | 2,736,018 | 99.99 | - | - | - |
| A | - | - | - | 2,478,451 | 2,478,451 | 97.28 |
| AA | - | - | - | 69,204 | 69,204 | 2.72 |
| | 2,736,206 | 2,736,206 | 100.00 | 2,547,655 | 2,547,655 | 100.00 |

The following are the amounts of foreign investments by the currency in which they are denominated as of June 30, 2011 and 2010:

| | 2011 | | | 2010 | | |
|---|---|---|---|---|---|---|
| Currency | FX Forwards | Rights | Warrants | FX Forwards | Rights | Warrants |
| | $ | $ | $ | $ | $ | $ |
| Australian Dollar | - | - | - | 367,196 | - | - |
| Brazilian Real | - | - | - | (510,309) | - | - |
| Canadian Dollar | - | - | - | (81,756) | - | - |
| English Pound Sterling | - | - | - | (603,992) | - | - |
| Euro | (391) | 153,078 | - | 293,614 | 191,452 | 722 |
| Hong Kong Dollar | - | 9,055 | - | - | 31,000 | 18,357 |
| Indian Rupee | - | - | - | 625,478 | - | - |
| Janpanese Yen | 38 | - | - | (2,226) | - | - |
| Norwegian Krone | - | - | - | - | 5,355 | - |
| Singapore Dollar | - | - | - | (991) | - | - |
| South Korean Won | - | - | - | 841 - | - | |
| Swedish Krona | - | - | - | (768) | - | - |
| Swiss Franc | - | - | - | (353,497) | - | - |
| Investments denominated in U. S. dollars | - | - | 66,421,545 | - | - | 65,354,031 |
| | (353) | 162,133 | 66,421,545 | (266,410) | 227,807 | 65,373,110 |

## *Note 3*
## *Member Systems' Participation*

| | General Assembly | Judges' | State Employees' | Combined* |
|---|---|---|---|---|
| **Member Systems' Income and Expenses Fiscal Year Ended June 30, 2011** | **$** | **$** | **$** | **$** |
| Interest and dividends | 1,338,206 | 13,747,518 | 253,329,661 | 268,415,385 |
| Net securities lending income | 17,455 | 179,176 | 3,297,810 | 3,494,441 |
| Net increase in fair value of investments | 9,098,602 | 93,118,822 | 1,708,270,995 | 1,810,488,419 |
| Total investment income | 10,454,263 | 107,045,516 | 1,964,898,466 | 2,082,398,245 |
| Administrative expenses | (183,751) | (1,901,411) | (35,138,357) | (37,223,519) |
| Net investment income | 10,270,512 | 105,144,105 | 1,929,760,109 | 2,045,174,726 |
| **Member Systems' Changes in Net Assets Fiscal Year Ended June 30, 2011** | | | | |
| Net assets at beginning of year | 51,638,586 | 506,463,522 | 9,120,601,694 | 9,678,703,802 |
| Member systems' net withdrawals | (4,562,656) | (23,813,049) | (167,877,799) | (196,253,504) |
| Net investment income | 10,270,512 | 105,144,105 | 1,929,760,109 | 2,045,174,726 |
| Net assets at end of year | 57,346,442 | 587,794,578 | 10,882,484,004 | 11,527,625,024 |

The source of net assets of the member systems since inception at June 30, 2011, is as follows:

| | General Assembly | Judges' | State Employees' | Combined* |
|---|---|---|---|---|
| Member systems' net withdrawals | (60,125,878) | (96,185,969) | (1,592,219,267) | (1,748,531,114) |
| Accumulated net investment income | 117,472,320 | 683,980,547 | 12,474,703,271 | 13,276,156,138 |
| Net assets at fair value | 57,346,442 | 587,794,578 | 10,882,484,004 | 11,527,625,024 |

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

*Note 3 (continued)*
*Member Systems' Participation*

| | General Assembly | Judges' | State Employees' | Combined* |
|---|---|---|---|---|
| **Member Systems' Income and Expenses Fiscal Year Ended June 30, 2010** | $ | $ | $ | $ |
| Interest and dividends | 1,328,731 | 12,492,628 | 229,493,021 | 243,314,380 |
| Net securities lending income | 35,978 | 336,363 | 6,232,988 | 6,605,329 |
| Net increase in fair value of investments | 3,590,964 | 31,522,768 | 598,899,494 | 634,013,226 |
| Total investment income | 4,955,673 | 44,351,759 | 834,625,503 | 883,932,935 |
| Administrative expenses | (207,114) | (1,952,648) | (35,525,015) | (37,684,777) |
| Net investment income | 4,748,559 | 42,399,111 | 799,100,488 | 846,248,158 |
| **Member Systems' Changes in Net Assets Fiscal Year Ended June 30, 2010** | | | | |
| Net assets at beginning of year | 47,693,753 | 435,604,601 | 8,200,755,918 | 8,684,054,272 |
| Member systems' net contributions/(withdrawals) | (803,726) | 28,459,810 | 120,745,288 | 148,401,372 |
| Net investment income | 4,748,559 | 42,399,111 | 799,100,488 | 846,248,158 |
| Net assets at end of year | 51,638,586 | 506,463,522 | 9,120,601,694 | 9,678,703,802 |

The source of net assets of the member systems since inception at June 30, 2010, is as follows:

| | General Assembly | Judges' | State Employees' | Combined* |
|---|---|---|---|---|
| Member systems' net withdrawals | (55,563,222) | (72,372,920) | (1,424,341,468) | (1,552,277,610) |
| Accumulated net investment income | 107,201,808 | 578,836,442 | 10,544,943,162 | 11,230,981,412 |
| Net assets at fair value | 51,638,586 | 506,463,522 | 9,120,601,694 | 9,678,703,802 |

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

## *Note 4*
## *Pensions*

### Plan Description

All of ISBI employees participate in the State Employees' Retirement System (SERS), which is a pension trust fund in the State of Illinois reporting entity. The SERS is a single-employer, defined benefit, public employee retirement system (PERS) in which State employees participate, except those covered by the State Universities, Teachers', General Assembly, and Judges' Retirement Systems. The financial position and results of operations of the SERS for fiscal years 2011 and 2010 are included in the State of Illinois' Comprehensive Annual Financial Report (CAFR). The SERS also issues a separate CAFR that may be obtained by writing to the SERS, 2101 Veterans Parkway, Springfield, IL 62794-9255 or by calling 217/785-7202. The State of Illinois CAFR may be obtained by writing to the State Comptroller's Office, Financial Reporting Department, 325 West Adams Street, Springfield, IL 62704-1858 or by calling 217/782-2053.

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

### Funding Policy

ISBI pays employer retirement contributions based upon an actuarially determined percentage of payroll. For fiscal year 2011 and 2010, the employer contribution rates were 27.988% and 28.377%, respectively. ISBI contributions to SERS for fiscal years 2011 and 2010 were $323,551 and $313,798, respectively, and were equal to the required contributions for each fiscal year.

Effective for pay periods beginning after December 31, 1991, the Board opted to pay the employee portion of retirement for ISBI employees covered by the State Employees' Retirement Systems. Generally, this pickup of employee retirement was part of the budget process and was, in part, a substitute for salary increases. In November 2010 the Board amended the policy to pay the employee portion of retirement to only apply to current employees as of the date of the policy change. New employees from that date forward must pay their own employee portion of retirement contributions. ISBI contributions to SERS for the employee portion for fiscal years 2011 and 2010 were $43,521 and $43,776, respectively.

### Member System Contributions and Withdrawals

Member systems' contributions are comprised solely of proceeds from bonds issued by the State of Illinois. As required by Public Act 96-1497, the State of Illinois issued $3.7 billion of General Obligation Bonds, Taxable Bond Series February 2011 on March 10, 2011 at an interest rate of 5.56%. The net bond proceeds were allocated among the five state-funded retirement systems to reduce their actuarial reserve deficiencies as provided in the Act. The State Employees' Retirement System, General Assembly Retirement System, and Judges' Retirement System received an allocation of bond proceeds equal to $745,546,496 on March 14, 2011. The monies were deposited into the Master Trust Account with the Illinois State Board of Investment the same day. The monies were combined with ISBI's other investments and invested in accordance with the asset allocation policy of ISBI during the year ended June 30, 2011. Contributions in the amount of $809,401,372 were made during fiscal year 2010. Member systems' withdrawals are determined by the member retirement systems based on the State's funding, the systems' benefit payment needs and the ability for ISBI to liquidate available assets. The total withdrawals for fiscal years 2011 and 2010 were $941,800,000 and $661,000,000, respectively.

### Post-retirement Benefits

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

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

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

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

Statement No. 62, *Codification of Accounting and Financial Reporting Guidance contained in pre-November 1989 FASB and AICPA Pronouncements*, was established to incorporate into the GASB's authoritative literature certain accounting and financial reporting guidance that is included in certain FASB and AICPA pronouncements issued on or before November 30, 1989, which does not conflict with or contradict GASB pronouncements. ISBI is required to implement this Statement for the year ending June 30, 2013.

Statement No. 63 *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources and Net Position,* was established to provide a framework that specifies where deferred outflows of resources and deferred inflows of resources, assets, liabilities and net position should be displayed on the financial statements. ISBI is required to implement this Statement for the year ending June 30, 2013.

Statement No. 64, *Derivative Instruments: Application of Hedge Accounting Termination Provisions – An Amendment to GASB Statement No. 53*, was established to enhance comparability and improve financial reporting by clarifying the circumstances in which hedge accounting should continue when a swap counterparty, or a swap counterparty's credit support provider, is replaced. ISBI is required to implement this Statement for the year ending June 30, 2012.

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

## *Note 6*
## *Subsequent Events (Unaudited)*

Subsequent to the June 30 fiscal year end, the overall financial markets experienced a decline in value. The decline in ISBI's investments as of October 31, 2011 is depicted in the strategic asset allocation chart below. The chart represents assets assigned to investment managers within each asset class, not by security type. Therefore, amounts noted below will differ from those as presented in the Statements of Plan Net Assets. The chart represents the most current information available for both public and private market investments as compared to June 30, 2011.

| | June 30 | Oct 31* | Increase/ (Decline) | Increase/ (Decline) |
|---|---|---|---|---|
| | $ | $ | $ | % |
| U.S. Equities | 3,380,198,858 | 3,241,223,055 | (138,975,803) | (4.11) |
| Commingled funds ** | 256,817,374 | 208,080,726 | (48,736,648) | (18.98) |
| Foreign equity securities | 2,195,201,185 | 2,002,588,947 | (192,612,238) | (8.77) |
| Foreign preferred stock | 40,032 | 206,197 | 166,165 | 415.08 |
| Fixed Income | 2,167,883,902 | 1,887,365,453 | (280,518,449) | (12.94) |
| Real Estate** | 819,053,366 | 809,618,861 | (9,434,505) | (1.15) |
| Private Equity** | 629,256,286 | 633,685,952 | 4,429,666 | 0.70 |
| Hedge Funds** | 1,075,584,754 | 997,862,476 | (77,722,278) | (7.23) |
| Infrastructure Funds** | 417,267,415 | 479,237,585 | 61,970,170 | 14.85 |
| Money market instruments | 303,501,465 | 216,097,627 | (87,403,838) | (28.80) |
| Bank Loans** | 253,447,070 | 307,092,370 | 53,645,300 | 21.17 |
| Foreign currency forward contracts | (353) | (36,366) | (36,013) | 10201.98 |
| Total Investments | 11,498,251,354 | 10,783,022,883 | (715,228,471) | (6.22) |

*October 31, 2011 information is based upon best available data on December 1, 2011 as recorded by ISBI's custodian and is prelimary and unaudited.

**Mark to market adjustments as of September 30, 2011 have been incorporated into ISBI custodian data and represents the most recent investment manager mark to market information to date.

McGladrey

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

Honorable William G. Holland
Auditor General
State of Illinois

Board of Trustees
Illinois State Board of Investment

As Special Assistant Auditors for the Auditor General, we have audited the Statements of Net Assets and Statements of Changes in Net Assets of the Illinois State Board of Investment (ISBI), as of and for the years ended June 30, 2011 and June 30, 2010, and have issued our report thereon dated December 14, 2011. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

Management of the Illinois State Board of Investment is responsible for establishing and maintaining effective internal control over financial reporting. In planning and performing our audit, we considered the ISBI's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, and not for the purpose of expressing an opinion on the effectiveness of the ISBI's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the ISBI's internal control over financial reporting.

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.

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

Compliance and Other Matters

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

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

McGladrey & Pullen, LLP

Schaumburg, Illinois
December 14, 2011