

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

Financial Statements  
June 30, 2018  
(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)

Table of Contents

	Schedule
	Page(s)
Agency Officials	1
Financial Statement Report:	
Summary	2
Independent Auditors' Report	3–4
Management's Discussion and Analysis (Unaudited)	5–7
Basic Financial Statements:	
Statement of Net Position	8
Statement of Changes in Net Position	9
Notes to the Financial Statements	10–29
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 <i>Government Auditing Standards</i>	30–31
Schedule of Findings and Responses	32

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

**AGENCY OFFICIALS**

Executive Director (Current)	Ms. Johara Farhadieh
Executive Director (7/1/17 to 6/30/18)	Mr. William R. Atwood
Director of Operations, Accounting and Audit	Mr. David Zaloga
Chief Fiscal Officer	Ms. Genette Bacon-Cordova
General Counsel/Chief Compliance Officer	Mr. Dipesh Mehta

Illinois State Board of Investment Office is located at:

180 North LaSalle Street  
Suite 2015  
Chicago, Illinois 60601

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

**Financial Statement Report Summary**

The audit of the accompanying financials statements of the Illinois State Board of Investment (ISBI) as of and for the year ended June 30, 2018 was performed by KPMG LLP. Based on their audit, the auditors expressed an unmodified opinion on ISBI's basic financial statements.

**Summary of Findings**

Number of:	<u>Current Report</u>	<u>Prior Year Report</u>
Findings	1	1
Repeated findings	1	None
Prior recommendations implemented or not repeated	None	None

**Exit Conference**

The findings and recommendations appearing in this report were discussed with ISBI personnel at an exit conference on December 6, 2018.

Attending were:

**Illinois State Board of Investment**

Mary Schostok, Audit Committee Chair  
Johara Farhadieh, Executive Director and Chief Investment Officer  
David Zaloga, Director of Operations, Accounting and Audit  
Dipesh Mehta, General Counsel/Chief Compliance Officer

**KPMG**

Catherine Baumann, Partner  
Anthony Solano, Senior Manager  
Adam Laurenti, Senior Associate

**Illinois Office of the Auditor General**

Thomas L. Kizziah, Audit Manager

The response to the finding was received in an email dated December 7, 2018 from David Zaloga, Director of Operations, Accounting and Audit.



KPMG LLP  
Aon Center  
Suite 5500  
200 E. Randolph Street  
Chicago, IL 60601-6436

## Independent Auditors' Report

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

### Report on the Financial Statements

As Special Assistant Auditors for the Auditor General of the State of Illinois, we have audited the accompanying Statement of Net Position of the Illinois State Board of Investment (ISBI), an internal investment pool of the State of Illinois, as of June 30, 2018, and the related Statement of Changes in Net Position for the year then ended and the related notes to the financial statements. We have also audited ISBI's investment trust funds, the Illinois State Board of Investment Member Systems and the Illinois Power Agency Trust Fund (the Trust Funds) as of and for the year ending June 30, 2018. ISBI and the Trust Funds collectively comprise the basic financial statements as listed in the table of contents.

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

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

#### *Auditors' Responsibility*

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

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

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



### *Opinions*

In our opinion, the financial statements referred to above present fairly, in all material respects, the net position of ISBI and the Trust Funds, as of June 30, 2018, and the changes in net position for the year then ended, in accordance with U.S. generally accepted accounting principles.

### *Other Matters*

#### Required Supplementary Information

U.S. generally accepted accounting principles require that the management's discussion and analysis on pages 5-7 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

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

In accordance with *Government Auditing Standards*, we have also issued our report dated December 12, 2018 on our consideration of ISBI and the Trust Funds' internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements and other matters. The purpose of that report is solely 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 effectiveness of ISBI and the Trust Funds' internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* in considering ISBI and the Trust Funds' internal control over financial reporting and compliance.

/s/ KPMG LLP

Chicago, Illinois  
December 12, 2018

## **Illinois State Board of Investment**

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

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

The following Management's Discussion and Analysis (MD&A) provides an introduction and overview of the Illinois State Board of Investment (ISBI) financial activities for the fiscal years ended June 30, 2018 and 2017.

#### **Financial Highlights**

The net position of ISBI totaled approximately \$18.3 billion at fiscal year end June 30, 2018, compared to approximately \$17.3 billion at June 30, 2017. The increase from the previous year is primarily the result of investment income.

#### **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 may experience significant changes on a daily basis.

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

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

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

The increase in investments at June 30, 2018 is a result of an investment gain of 7.6% for the fiscal year, net of expenses which are shown in the Statement of Changes in Net Position. The decrease in liabilities and receivables for fiscal 2018 compared with 2017 is due to less pending investment purchases and sales at year-end 2018.

**Illinois State Board of Investment**

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

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**Condensed Summary of Net Position  
June 30**

	<u>2018</u>	<u>2017</u>	<u>Change</u>
Cash	\$ 14,286,287	8,536,289	5,749,998
Receivables	96,935,828	145,523,579	(48,587,751)
Investments	18,320,775,728	17,368,102,543	952,673,185
Securities lending collateral	—	8,649,676	(8,649,676)
Prepaid expenses	76,713	11,167	65,546
Capital assets	<u>61,199</u>	<u>59,220</u>	<u>1,979</u>
Total assets	18,432,135,755	17,530,882,474	901,253,281
Liabilities	<u>95,701,306</u>	<u>224,584,269</u>	<u>(128,882,963)</u>
Total net position	<u>\$ 18,336,434,449</u>	<u>17,306,298,205</u>	<u>1,030,136,244</u>

The Statement of Changes in Net Position presents information regarding changes during the fiscal year ended June 30, 2018. 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.

The net investment income for the year ended June 30, 2018 was the result of upward movement in the securities markets. There was also an increase in withdrawals by the member systems. Fiscal year 2018 withdrawals were \$313.6 million compared with \$232.6 million in fiscal year 2017. Withdrawals are determined by the member retirement systems based on the State of Illinois' funding and the Member Systems' benefit payment needs. The decrease in administrative expenses for fiscal year 2018 compared to 2017 is primarily due to a reduction of investment management fees and the continuation of the process of implementing ISBI's investment policy statement which establishes a goal of allocating two-thirds of the portfolio to passive management and one-third of the portfolio to active management.

**Illinois State Board of Investment**

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

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**Condensed Statement of Changes in Net Position  
Fiscal Years Ended June 30**

	<u>2018</u>	<u>2017</u>	<u>Change</u>
Additions:			
Net investment income	\$ 1,358,670,542	1,948,759,765	(590,089,223)
Contributions from the State of Illinois	<u>12,300,000</u>	<u>19,000,000</u>	<u>(6,700,000)</u>
Total additions	<u>1,370,970,542</u>	<u>1,967,759,765</u>	<u>(596,789,223)</u>
Deductions:			
Member Systems' withdrawals	313,625,223	232,550,000	81,075,223
Administrative expenses	<u>27,209,075</u>	<u>30,580,085</u>	<u>(3,371,010)</u>
Total deductions	<u>340,834,298</u>	<u>263,130,085</u>	<u>77,704,213</u>
Net increase (decrease) in net position	<u>\$ 1,030,136,244</u>	<u>1,704,629,680</u>	<u>(674,493,436)</u>

**Future Outlook**

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

In the future, ISBI plans to continue to accomplish its strategy of seeking to maximize the likelihood of meeting long-term return objectives while maintaining prudent risk exposure, controlling fees and expenses related to the management of the fund and complying with the governing provisions of the Illinois Pension Code (40 ILCS 5/1 et seq.) and other applicable laws and regulations. Long-term return objectives are based on assumed rates of return set forth by the individual retirement systems.

**Illinois State Board of Investment  
Statement of Net Position  
June 30, 2018**

	<b>Illinois State Board of Investment Member Systems</b>	<b>Illinois Power Agency Trust Fund</b>	<b>Total Illinois State Board of Investment</b>
<b>Assets:</b>			
Cash	\$ 14,256,203	30,084	14,286,287
Receivables:			
Foreign taxes	9,968,091	21,035	9,989,126
Accounts receivable	803,294	1,695	804,989
Investments sold	39,447,703	83,242	39,530,945
Interest and dividends	46,512,617	98,151	46,610,768
Total receivables	96,731,705	204,123	96,935,828
Prepaid expenses	76,552	161	76,713
Capital assets	55,856	118	55,974
Capital lease	5,214	11	5,225
Investments:			
Measured at fair value:			
Government and agency obligations	3,765,051,555	7,945,002	3,772,996,557
Foreign obligations	316,403,682	667,674	317,071,356
Corporate obligations	976,096,074	2,059,756	978,155,830
Municipal bonds	8,892,399	18,765	8,911,164
Common stock and equity funds	5,216,211,086	11,007,236	5,227,218,322
Commingled funds	1,718,213,289	3,625,769	1,721,839,058
Foreign equity securities	2,296,434,921	4,845,931	2,301,280,852
Foreign preferred stock	8,745,516	18,454	8,763,970
Hedge funds	359,984,365	759,638	360,744,003
Opportunistic debt	224,579,428	473,907	225,053,335
Real estate funds	1,591,416,371	3,358,203	1,594,774,574
Private equity	705,279,991	1,488,279	706,768,270
Infrastructure	408,124,365	861,402	408,985,767
Bank loans	463,338,185	977,735	464,315,920
Foreign currency forward contracts	(7,830,538)	(16,524)	(7,847,062)
Measured at amortized cost:			
Money market instruments	231,255,816	487,996	231,743,812
Total investments	18,282,196,505	38,579,223	18,320,775,728
Total assets	18,393,322,035	38,813,720	18,432,135,755
<b>Liabilities:</b>			
Payables:			
Investments purchased	87,758,142	185,186	87,943,328
Administrative expenses	7,736,427	16,326	7,752,753
Capital lease obligation	5,214	11	5,225
Total liabilities	95,499,783	201,523	95,701,306
Net position	\$ 18,297,822,252	38,612,197	18,336,434,449

See notes to financial statements, pages 10 - 29.

**Illinois State Board of Investment  
Statement of Changes in Net Position  
Year ended June 30, 2018**

	<b>Illinois State Board of Investment Member Systems</b>	<b>Illinois Power Agency Trust Fund</b>	<b>Total Illinois State Board of Investment</b>
<b>Additions:</b>			
Investment income:			
Net increase in fair value of investments	\$ 955,091,039	2,042,800	957,133,839
Interest and other	226,574,262	486,555	227,060,817
Dividends	172,288,545	369,979	172,658,524
Securities lending income	2,037,472	4,338	2,041,810
Securities lending rebates	(86,239)	(184)	(86,423)
Securities lending expense	(137,732)	(293)	(138,025)
Total investment income	<u>1,355,767,347</u>	<u>2,903,195</u>	<u>1,358,670,542</u>
Contributions from the State of Illinois	<u>12,300,000</u>	<u>—</u>	<u>12,300,000</u>
Total additions	<u>1,368,067,347</u>	<u>2,903,195</u>	<u>1,370,970,542</u>
<b>Deductions:</b>			
Administrative expenses:			
Salaries and benefits:			
Salaries	1,330,298	2,862	1,333,160
Benefits	924,603	1,990	926,593
Operating expenses:			
Rent and utilities	249,690	537	250,227
Audit	242,478	522	243,000
Other	614,700	1,323	616,023
External support:			
Custody	548,819	1,181	550,000
Consulting and professional	1,344,519	2,893	1,347,412
Investment advisors/managers	21,569,739	46,412	21,616,151
Investment services and research	325,808	701	326,509
Total administrative expenses	<u>27,150,654</u>	<u>58,421</u>	<u>27,209,075</u>
Member Systems' withdrawals	<u>312,500,000</u>	<u>1,125,223</u>	<u>313,625,223</u>
Total deductions	<u>339,650,654</u>	<u>1,183,644</u>	<u>340,834,298</u>
Increase in net position	1,028,416,693	1,719,551	1,030,136,244
Net position at beginning of year	<u>17,269,405,559</u>	<u>36,892,646</u>	<u>17,306,298,205</u>
Net position at end of year	<u>\$ 18,297,822,252</u>	<u>38,612,197</u>	<u>18,336,434,449</u>

See notes to financial statements, pages 10 - 29.

## Illinois State Board of Investment

### Notes to Financial Statements

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

##### **Reporting Entity**

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

The assets of the Member Systems and the Trust Fund are accounted for in a single commingled fund. Separate information on each System's participation is presented in Note 3. The assets of the Trust Fund came under management of ISBI in fiscal year 2012. The assets and liabilities of the Member Systems and Trust Fund are reported on the Statement of Net Position. The revenues and expenses for the Member Systems and Trust Fund for fiscal year 2018 are reported on the Statement of Changes in Net Position.

##### **Basis of Accounting**

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

##### **Valuation of Investments**

Investments owned are reported at fair value as follows: (1) U.S. Government and Agency, Foreign and Corporate Obligations, Convertible Bonds – prices quoted by a major dealer in such securities; (2) Common Stock and Equity Funds, Foreign Preferred Stock, Foreign Equity Securities, Forward Foreign Currency Contracts and Options: (a) Listed – closing prices as reported on the composite summary of national securities exchanges; (b) Over-the-counter – bid prices; (3) Money Market Instruments – amortized cost; (4) Real Estate Investments – fair values based on audited financial statements of the funds and then adjusted by ISBI and its investment managers for activity from audit date to fiscal year end; (5) Alternative Investments (Private Equity, Hedge funds, Bank Loans, Opportunistic Debt and Infrastructure) – fair values based on audited financial statements of the funds and then adjusted by ISBI and its investment managers for activity from audit date to fiscal year end; (6) Commingled funds – fair values based on audited financial statements of the funds and then adjusted by ISBI and its investment managers for activity from audit date to fiscal year end.

##### **Investment Transactions and Investment Income**

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

##### **Custody and Investment Management Fees**

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

## Illinois State Board of Investment

### Notes to Financial Statements

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

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

Northern Trust Company (Northern Trust) provides custody services for the assets managed by ISBI. These services include safekeeping and transaction processing services for all pension assets of the Member Systems and the Trust Fund. Northern Trust also provides cash management services and all necessary reporting for pension assets including performance reporting and accounting reports. Custody fees paid to Northern Trust are paid based on a fixed fee paid on a quarterly basis per the Custodian Contract for performance and analytics services and various accounting data interface feeds.

#### **Risk Management**

ISBI, as part of the State, provides for risks of loss associated with workers' compensation and general liability through the State's self-insurance program, which handles processing of all claims. ISBI obtains commercial insurance for fidelity and surety and property. There have been no commercial insurance claims in the past five years. ISBI also maintains governmental fiduciary liability policies to insure against the risk of potential claims related to a breach of responsibilities, obligations, or duties imposed by applicable laws or regulations.

#### **Risks and Uncertainties**

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

#### **Use of Estimates**

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

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

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

## Illinois State Board of Investment

### Notes to Financial Statements

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

##### **Compensated Absences**

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

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.

ISBI's policy related to vacation days earned for all employees under the jurisdiction of the State of Illinois Personnel Code and employees employed on or after January 1, 2011 not subject to the jurisdiction of the Personnel Code (non-code) is in accordance with the following schedule:

- From the date of hire until the completion of 5 years of continuous service – 10 work days per year
- From the completion of 5 to 9 years of continuous service – 15 work days per year
- From the completion of 9 to 14 years of service continuous – 17 work days per year
- From the completion of 14 to 19 years of service continuous – 20 work days per year
- From the completion of 19 to 25 years of service continuous – 22 work days per year
- From the completion of 25 years of service continuous – 25 work days per year

All employees of ISBI employed prior to January 1, 2011, not subject to the Personnel Code (non-code), earn vacation leave in accordance with the following schedule adopted by ISBI:

- From date of hire until completion of 1 year of continuous service – 15 work days per year
- From completion of 1 year of continuous service until the completion of 3 years continuous service – 20 work days per year
- Thereafter – 25 work days per year

On each employee's creditable service date any vacation time accumulated in excess of two year's vacation allowance, at the current rate will be forfeited.

## Illinois State Board of Investment

### Notes to Financial Statements

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

##### Capital Lease Obligation

ISBI has entered into a capital lease for office equipment. The capital lease is for a 60-month term with a purchase option for fair value at the end of the lease period. Future minimum commitments for the capital lease as of June 30, 2018 are as follows:

Capital Lease Year Ending June 30	Principal	Interest
2019	\$ 2,666	1,079
2020	2,666	656
2021	1,777	149
	\$ 7,109	1,884

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

##### Deposits

Custodial credit risk for deposits is the risk that, in the event of a financial institution failure, ISBI's deposits may not be returned. All non-investment related bank balances at year-end are insured or collateralized with securities held by the Illinois State Treasurer or agents in the name of the State Treasurer. As of June 30, 2018, ISBI had non-investment related bank balances of \$903,541. 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 Northern Trust which has an A+ Long-term Deposit/Debt rating by Standard & Poor's and an A2 rating by Moody's. Certain investments of ISBI with maturities of 90 days or less would be considered cash equivalents; these consist of short-term investment funds and U.S. Treasury bills with maturities of 90 days or less, which are not subject to the custodial credit risk. For financial statement presentation and investment purposes, ISBI reports these types of cash equivalents as Money Market Instruments in the Statement of Net Position. As of June 30, 2018, ISBI had investment related bank balances of \$13,382,746. These balances include USD and foreign cash balances. Cash held in the investment related bank account is neither federally insured nor collateralized for amounts in excess of \$250,000. However, ISBI is the beneficiary of multiple policies and bonds held by Northern Trust providing for recovery of various potential losses related to services provided by Northern Trust as ISBI's custodian. At any given point and time, the foreign cash balances may be exposed to custodial credit risk.

##### Enabling Statute/Investment Policy

ISBI's investment authority and responsibilities are specified in the Illinois Compiled Statutes, 40 ILCS 5/1 and 40 ILCS 5/22A. These statutes provide ISBI with the authority to manage and invest certain assets.

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

40 ILCS 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..."

## Illinois State Board of Investment

### Notes to Financial Statements

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

ISBI has developed a formal investment policy, which has been approved by the board of trustees, that outlines investment objectives and philosophies that are implemented in order to achieve the mandates established by the enabling statute.

#### **Investment Commitments**

ISBI had total unfunded investment commitments of \$2.1 billion at the end of fiscal year 2018. The Real Estate, Private Equity, Infrastructure, and Opportunistic Debt investment portfolios consist of passive interests in limited partnerships. At the end of fiscal year 2018, ISBI had no outstanding commitments to separate real estate accounts within the Real Estate and Private Equity investment portfolios. ISBI will fund outstanding commitments by utilizing available cash and then selling liquid securities in the portfolio as necessary.

#### **Investment Liquidity**

The majority of ISBI's portfolio is highly liquid, however, ISBI holds investments in hedge funds, real estate funds, opportunistic debt funds, private equity funds, and infrastructure funds that are considered illiquid by the very nature of the investment. Market risk exists as ISBI may not be able to exit from the illiquid investments during periods of significant market value declines.

#### **Rate of Return**

For the year ended June 30, 2018, the annual money-weighted rate of return on pension plan investments, net of pension plan investment expense, was 7.6 percent. The money-weighted rate of return expresses investment performance, net of investment expense, adjusted for the changing amounts invested. As of June 30, 2018, the money-weighted rate of return on pension plan investments, net of pension plan investment expense since inception (June 30, 1970), was 8.2 percent

## Illinois State Board of Investment

### Notes to Financial Statements

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

##### Fair Value Measurements

For the year ended June 30, 2018, ISBI had the following recurring fair value measurements:

Investments by fair value level	Fair Value Measurements Using			Totals
	Level 1	Level 2	Level 3	
Debt securities:				
Government and agency obligations	\$ —	3,772,996,557	—	3,772,996,557
Municipal Bonds	—	8,911,164	—	8,911,164
Foreign obligations	—	316,170,777	900,579	317,071,356
Corporate obligations	—	973,728,079	4,427,751	978,155,830
Bank loans	—	36,604,268	427,711,652	464,315,920
Total debt securities	—	5,108,410,845	433,039,982	5,541,450,827
Equity securities:				
Common stock and equity funds	5,226,061,569	1,134,591	22,162	5,227,218,322
Foreign equity securities	2,297,170,419	3,662,373	448,060	2,301,280,852
Foreign preferred stock	8,763,970	—	—	8,763,970
Total equity securities	7,531,995,958	4,796,964	470,222	7,537,263,144
Other:				
Foreign currency forward contracts	(7,847,062)	—	—	(7,847,062)
Total other	(7,847,062)	—	—	(7,847,062)
Total investments by fair value level	\$ 7,524,148,896	5,113,207,809	433,510,204	13,070,866,909
Investments measured at Net Asset Value (NAV):				
Commingled funds				\$ 1,721,839,058
Real estate funds				1,594,774,574
Private equity				706,768,270
Infrastructure				408,985,767
Opportunistic debt				225,053,335
Hedge funds				360,744,003
Total investments measured at NAV				5,018,165,007
Investments not measured at fair value:				
Money market instruments				231,743,812
Total investments				\$ 18,320,775,728

## Illinois State Board of Investment

### Notes to Financial Statements

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

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

Level 1 – Unadjusted quoted prices in active markets for identical assets.

Level 2 – Inputs other than quoted prices that are observable for the asset, either directly or indirectly. These inputs include:

- (a) Quoted prices for similar assets in active markets;
- (b) Quoted prices for identical or similar assets in markets that are not active;
- (c) Inputs other than quoted prices that are observable for the asset; or
- (d) Inputs that are derived principally from or corroborated by observable market data by correlation or other means.

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

Valuation methodologies are as follows:

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

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

## Illinois State Board of Investment

### Notes to Financial Statements

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

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

<b>Investments Measured at NAV June 30, 2018</b>	<b>Fair Value</b>	<b>Unfunded Commitments</b>	<b>Redemption Frequency</b>	<b>Redemption Notice Period</b>
Commingled funds	\$ 1,721,839,058	—	Quarterly	90 days
Real estate funds	1,594,774,574	713.3 million	Quarterly	90 days
Private equity	706,768,270	707.6 million	N/A	N/A
Opportunistic debt	225,053,335	660.1 million	N/A	N/A
Hedge funds	360,744,003	—	Quarterly	90 days
Infrastructure	<u>408,985,767</u>	23.5 million	Quarterly	90 days
Total investments measured at NAV	<u>\$ 5,018,165,007</u>			

#### Alternative Investments

ISBI's investments in Alternative Investment vehicles consist of Commingled Funds, Private Equity Funds, Hedge Funds, Infrastructure Funds, Opportunistic Debt Funds, and Real Estate Funds. These types of vehicles are 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.

- 1) Commingled Funds – ISBI's investments in this category consist of assets that are blended together with other investments in order to provide economies of scale which allows for lower trading costs per dollar of investment and diversification. These investments provide primarily liquid exposure to publicly traded equity and fixed income markets. The equity portfolios provide diversification benefits and return enhancement to the overall fund in both domestic and international equity markets. Commingled funds are also called "pooled funds" and "master trusts". Investment strategies consist of investments in six diversified funds focusing on emerging markets and six long-only equity funds. The fair value of these investments is based on audited financial statements of the funds adjusted for activity from the audit date to year end. ISBI has no plans to liquidate these investments as of June 30, 2018. It is probable that any investments sold will be sold at an amount different from the current NAV of the plan's ownership interest.
- 2) Private Equity – ISBI's assets in this category consist of investments in funds not listed on public exchanges. Investment strategies consist of investments in sixty-five funds with the goals of generating returns significantly greater than typically available in the public market and diversifying ISBI's overall portfolio which is comprised predominantly of fixed income and equity assets. The strategies of Private Equity funds include, but are not limited to, leveraged buyouts, venture capital, growth capital and mezzanine capital. Returns are commensurate with the risks presented by this asset class which include illiquidity and lack of standard historical evaluation data. The fair value of these investments is based on audited financial statements of the funds adjusted for activity from the audit date to year end. ISBI has no plans to liquidate these investments as of June 30, 2018. It is probable that any investments sold will be sold at an amount different from the current NAV of the plan's ownership interest.

## Illinois State Board of Investment

### Notes to Financial Statements

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

- 3) Hedge Funds – ISBI is currently in the process of transitioning investments in hedge fund vehicles to long-only equity vehicles. Assets in this category have historically consisted of investments in funds that seek to generate better than average return and provide a hedge against a downward trend in the overall market. Investment strategies currently consist of investments in eighteen funds including hedge fund and long only equity assets. Returns are commensurate with the risks presented by this asset class which include illiquidity and lack of standard historical evaluation data. The fair value of these investments is based on audited financial statements of the funds adjusted for activity from the audit date to year end. As of June 30, 2018, for the majority of the hedge fund investments, ISBI has plans to transition out entirely or to long only equity assets. It is probable that any investments sold will be sold at an amount different from the current NAV of the plan's ownership interest.
- 4) Infrastructure – ISBI's assets in this category consist of investments in funds that identify infrastructure assets which provide essential services or facilities to a community (ports, bridges toll roads, etc.) and are typically made as a part of a privatization initiative on the part of a government entity. Investment strategies consist of investments in six funds with the goals of diversifying ISBI's overall portfolio which is comprised predominantly of fixed income and equity assets and providing capital appreciation and income generation. The fair value of these investments is based on audited financial statements of the funds adjusted for activity from the audit date to year-end. ISBI has no plans to liquidate these investments as of June 30, 2018. It is probable that any investments sold will be sold at an amount different from the current NAV of the plan's ownership interest.
- 5) Opportunistic Debt – ISBI's assets in this category consist of investments in private fixed income markets. Investment strategies consist of investments in seventeen funds with the goals of diversifying ISBI's overall portfolio, providing downside protection through assets that are capital collateralized and supplementing the total return of the portfolio which is comprised predominantly of fixed income and equity assets. The fair value of these investments is based on audited financial statements of the funds adjusted for activity from the audit date to year-end. ISBI has no plans to liquidate these investments as of June 30, 2018. It is probable that any investments sold will be sold at an amount different from the current NAV of the plan's ownership interest.
- 6) Real Estate Funds – ISBI's assets in this category consist of investments in the Core and Non-Core Real Estate Fund categories. Investment strategies consist of investments in thirty-six funds with the goals of diversifying ISBI's overall portfolio, providing capital appreciation and supplementing the total return of the portfolio through exposure to private real estate assets in both open-end and closed-end structures. Investments in this category are globally diversified and consist of office, industrial, multi-family, storage and other types of assets. Core assets are expected to provide strong diversification through primary markets and high-income potential. Non-Core assets are typically higher risk assets with stronger capital appreciation. The fair value of these investments is based on audited financial statements of the funds adjusted for activity from the audit date to year-end. ISBI has no plans to liquidate these investments as of June 30, 2018. It is probable that any investments sold will be sold at an amount different from the current NAV of the plan's ownership interest.

In addition, certain real estate investments are leveraged whereby partnerships have been established to purchase properties through a combination of contributions from ISBI and through acquisition of debt. At June 30, 2018, real estate equities of approximately \$1,595 million are reported at estimated fair value. Of this amount, \$1,679 million are net assets offset by \$84 million in long-term debt.

**Illinois State Board of Investment**

**Notes to Financial Statements**

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

Required repayment of real estate debt, which is non-recourse debt, is as follows as of June 30, 2018:

<b>Debt Maturities</b>	
<b>Year Ending June 30</b>	
2019	\$ 25,492,500
2020	<u>57,963,872</u>
	<u>\$ 83,456,372</u>

**Concentration of Credit Risk and Credit Risk for Investments**

ISBI's portfolio of investments is managed by professional investment management firms. These investment management firms are required to maintain diversified portfolios. Each investment manager must comply with risk management guidelines individually assigned to them as part of their investment management agreement. ISBI did have one issuer investment that exceeded 5% of the total investments of ISBI as of June 30, 2018. This security was U.S. Treasury Notes/Bills with a Moody's rating of Aaa. This investment represented 7.0% of the investments of ISBI.

The following table presents the quality ratings of debt securities held by ISBI as of June 30, 2018:

	<b>Moody's</b>	
	<b>Quality Rating</b>	
U.S. government obligations and agency obligations	AAA	\$ 3,763,976,415
	AA	—
	A	—
	Not rated	<u>9,020,142</u>
	Total U.S. government and agency obligations	<u>\$ 3,772,996,557</u>
Municipal obligations	AAA	\$ 838,626
	AA	1,511,700
	A	1,269,124
	CA	19,320
	Not rated	<u>5,272,394</u>
Total municipal obligations	<u>\$ 8,911,164</u>	
Foreign obligations	AAA	\$ 41,977,946
	AA	27,460,930
	A	54,344,245
	BAA	59,881,915
	BA	27,877,269
	B	47,658,967
	CAA	19,185,346
	CA	740,870

Illinois State Board of Investment

Notes to Financial Statements

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

	<b>Moody's Quality Rating</b>	
	C	\$ 487,825
	Not rated	<u>37,456,043</u>
Total foreign obligations		<u>\$ 317,071,356</u>
Corporate obligations:		
Bank and finance	AAA	\$ 30,463,803
	AA	1,918,280
	A	186,631,850
	BAA	40,936,878
	BA	17,326,045
	B	10,584,845
	CAA	1,040,188
	C	192,675
	Not rated	<u>17,851,432</u>
Total bank and finance		<u>306,945,996</u>
Industrial	AAA	170,855
	AA	55,479
	A	16,784,165
	BAA	22,770,802
	BA	7,207,064
	B	27,952,272
	CAA	10,735,935
	CA	—
	Not rated	<u>6,746,910</u>
Total industrial		<u>92,423,482</u>
Other	AAA	12,892,695
	AA	39,432,846
	A	131,626,425
	BAA	140,301,493
	BA	56,287,806
	B	117,871,856
	CAA	52,532,525
	CA	761,400
	C	546,904
	Not rated	<u>26,532,402</u>
Total other		<u>578,786,352</u>
Total corporate obligations		<u>\$ 978,155,830</u>
Bank loans	Not rated	<u>\$ 464,315,920</u>
Total bank loans		<u>\$ 464,315,920</u>
Money market	Not rated	<u>\$ 231,743,812</u>
Total money market		<u>\$ 231,743,812</u>

## Illinois State Board of Investment

### Notes to Financial Statements

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

##### **Custodial Credit Risk for Investments**

The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, ISBI will not be able to recover the value of investments or collateral securities that are in the possession of counterparty. As of June 30, 2018, 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 consistent with the Barclay's U.S. Universal Index (benchmark index). As of June 30, 2018, the effective weighted duration of ISBI's fixed income portfolio was 6.7 years and the effective duration of the benchmark index was 5.8 years.

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. Below is the detail of ISBI's duration by investment type as of June 30, 2018:

<u>Investment Type</u>	<u>Fair Value</u>	<u>Effective Weighted Duration</u> Years
Government and agency obligations:		
U.S. government	\$ 3,051,823,420	8.4
Federal agency	721,173,137	5.4
Municipal obligations	8,911,164	10.7
Foreign obligations	317,071,356	5.3
Corporate obligations:		
Bank and finance	306,945,996	3.3
Industrial	92,423,482	5.7
Other	578,786,352	5.1
	<u>\$ 5,077,134,907</u>	

For the ISBI bank loans portfolio the appropriate measure of interest rate risk is weighted average maturity. Weighted average maturity is the average time it takes for securities in a portfolio to measure weighted in proportion to the dollar amount that is invested in the portfolio. Weighted average maturity measures the sensitivity of fixed-income portfolios to interest rate changes. At June 30, 2018 the weighted average maturity of ISBI's bank loan portfolio was 5.1 years.

##### **Foreign Currency Risk**

The international portfolio is constructed on the principles of diversification, quality, growth, and value. Risk of loss arises from changes in currency exchange rates and other factors. Certain investments held in infrastructure and Real Estate funds trade in a reported currency of Euro-based dollars valued at \$120,121,360 as of June 30, 2018. The following table presents the foreign currency risk by type of investment as of June 30, 2018:

Illinois State Board of Investment

Notes to Financial Statements

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

	<b>Foreign Equity Securities and Foreign Preferred Stock</b>	<b>Foreign Obligations</b>
Australian Dollar	\$ 140,703,692	—
Brazilian Real	2,328,245	—
Canadian Dollar	34,869,856	—
Czech Koruna	—	—
Danish Krone	34,178,475	—
English Pound Sterling	379,925,049	—
Euro Currency	697,623,140	—
Hong Kong Dollar	81,794,995	—
Japanese Yen	563,029,069	—
Mexican Peso	2,758,008	—
New Israeli Sheqel	9,802,812	—
New Zealand Dollar	—	—
Norwegian Krone	23,598,464	—
Singapore Dollar	26,008,370	—
South African Rand	5,241	—
South Korean Won	15,771,428	—
Swedish Krona	65,000,505	—
Swiss Franc	167,379,349	—
Thailand Baht	3,152,176	—
UAE Dirham	464,120	—
denominated in U.S. Dollars	<u>61,651,828</u>	<u>317,071,356</u>
	<u>\$ 2,310,044,822</u>	<u>317,071,356</u>

## Illinois State Board of Investment

### Notes to Financial Statements

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

##### **Securities Lending**

ISBI participated in a securities lending program with Deutsche Bank AG, New York Branch as of June 30, 2018 who acts as securities lending agent. ISBI is in the process of winding down this program and therefore, as of June 30, 2018 there were no outstanding loans or balances associated with any of the related financial statement accounts on the Statement of Net Position. Public markets securities are loaned to brokers and, in return, ISBI receives cash and non-cash collateral. All of the public market securities were eligible for the securities lending program. Collateral consists solely of cash, government securities, and certain equity securities having a fair value equal to or exceeding 102% of the value of the loaned securities (105% for non-U.S. securities). In the event of borrower default, Deutsche Bank AG, New York Branch provides ISBI with counterparty default indemnification. Investments in the cash collateral account represent securities that were distributed to ISBI in connection with the in-kind redemption of ISBI's ownership in the State Street Bank and Trust Company Quality Funds for Short-Term Investment (Quality D). Deutsche Bank is not responsible for any losses with regards to these legacy investments. This arrangement subjects ISBI to credit risk as the credit quality of these investments may decline over time. The credit risk on the legacy investments is the risk of a possible loss arising from the inability of counterparty to meet its obligations. This loss could include the loss of principal, interest and/or decreased expected cash flows in any of the investments held in ISBI's cash collateral account. In the event counterparty defaults on its obligations, ISBI would need to credit the cash collateral account with the amount of the default to make the account whole so that once loaned securities are returned, the cash pledged by borrowers can be returned to them.

##### **Derivative Securities**

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

Foreign currency forward contracts (FX forwards) are used to protect against the currency risk in ISBI's foreign equity portfolio. A foreign currency forward contract is an agreement to buy or sell a specific amount of a foreign currency at a specified delivery or maturity date for an agreed-upon price. Fluctuations in the market value of foreign currency forward contracts are marked to market on a daily basis. These investments are reported at fair value in the investment section of the Statement of Net Position. The gain or loss arising from the difference between the original contracts and the closing of such contracts is recognized in the net increase/decrease in the fair value of investments in the Statement of Changes in Net Position. As of June 30, 2018, all foreign currency forward contracts are held by ISBI's custodian and one investment manager, Northern Trust Asset Management, which is permitted per the investment guidelines to invest in this type of contract under established guidelines.

## Illinois State Board of Investment

### Notes to Financial Statements

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

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

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

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

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

## Illinois State Board of Investment

### Notes to Financial Statements

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

The following table presents the investment derivative instruments aggregated by type that were held by ISBI as of June 30, 2018:

	<u>Changes in Fair Value</u>	<u>Fair Value at Year End</u>	<u>Notional Amount</u> Number of shares
FX forwards	\$ 3,646,386	(7,847,062)	—
Futures	—	—	276
Rights/Warrants	<u>50,984</u>	<u>181,512</u>	<u>435,088</u>
	<u>\$ 3,697,370</u>	<u>(7,665,550)</u>	<u>435,364</u>

Rights and Warrants are included in the Common Stock and Equity Funds line of the Statement of Net Position

The table below shows the futures positions held by ISBI as of June 30, 2018:

	<u>Number of Contracts</u>	<u>Contract Principal*</u>
Equity futures purchased	263	\$ 29,211,622
Fixed income futures purchased		
Fixed income futures sold	13	(1,562,438)

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

Derivative transactions involve, to varying degrees, credit risk, and market risk. Credit risk is the possibility that a loss may occur because a party to a transaction fails to perform according to terms. Derivatives which are exchange traded are not subject to credit risk. No derivatives held are subject to custodial credit risk. Market risk is the possibility that a change in interest (interest rate risk) or currency rates (foreign currency risk) will cause the value of a financial instrument to decrease or become more costly to settle. The market risk associated with derivatives, the prices of which are constantly fluctuating, is regulated by imposing strict limits as to the types, amounts, and degree of risk that investment managers may undertake. These limits are approved by the Board of Trustees and management of ISBI and the risk positions of the investment managers are reviewed on a periodic basis to monitor compliance with the limits. As of June 30, 2018, ISBI held futures contracts whose underlying instruments were exposed to interest risk but there were no GASB 53 reportable elements. ISBI has not adopted a formal policy specific to master netting arrangements.

## Illinois State Board of Investment

### Notes to Financial Statements

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

ISBI's derivative investments in foreign currency forward contracts are held with counterparties. ISBI's counterparties were not rated and fair value and net exposure as of June 30, 2018 for these contracts were \$0.

The following table presents the fair value of derivative investments exposed to foreign currency risk as of June 30, 2018:

	<u>FX Forwards</u>	<u>Rights</u>
Australian Dollar	\$ (794,929)	2,265
English Pound Sterling	(1,706,100)	76,108
Euro Currency	(2,533,864)	103,139
Japanese Yen	<u>(2,812,170)</u>	<u>—</u>
	<u>\$ (7,847,063)</u>	<u>181,512</u>

## Illinois State Board of Investment

### Notes to Financial Statements

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

	General Assembly	Judges	State Employees'	Illinois State Board of Investment Member Systems	Power Agency	Total Illinois State Board of Investment *
<b>Member Systems' Income and Expenses</b>						
<b>Fiscal Year Ended June 30, 2018</b>						
Interest and dividends	\$ 1,098,601	20,954,935	376,809,271	398,862,807	856,534	399,719,341
Net securities lending income	5,040	95,964	1,712,497	1,813,501	3,861	1,817,362
Net realized gain on investments	2,550,442	48,666,023	877,102,247	928,318,712	1,995,681	930,314,393
Net unrealized gain on investments	60,217	1,149,030	25,563,080	26,772,327	47,119	26,819,446
Administrative expenses	(74,462)	(1,421,235)	(25,654,957)	(27,150,654)	(58,421)	(27,209,075)
Net investment income	<u>\$ 3,639,838</u>	<u>69,444,717</u>	<u>1,255,532,138</u>	<u>1,328,616,693</u>	<u>2,844,774</u>	<u>1,331,461,467</u>

#### Member Systems' Changes in Net Position

Fiscal Year Ended June 30, 2018

Net assets at beginning of period	\$ 47,148,104	899,652,119	16,322,605,336	17,269,405,559	36,892,646	17,306,298,205
Member systems' net contributions (withdrawals)	700,000	9,100,000	(310,000,000)	(300,200,000)	(1,125,223)	(301,325,223)
Net investment income	<u>3,639,838</u>	<u>69,444,717</u>	<u>1,255,532,138</u>	<u>1,328,616,693</u>	<u>2,844,774</u>	<u>1,331,461,467</u>
Net assets at end of period	<u>\$ 51,487,942</u>	<u>978,196,836</u>	<u>17,268,137,474</u>	<u>18,297,822,252</u>	<u>38,612,197</u>	<u>18,336,434,449</u>

The source of net assets of the member systems since inception at June 30, 2018, is as follows:

Member systems' net contributions (withdrawals)	\$ (91,150,877)	(88,585,969)	(2,502,826,845)	(2,682,563,691)	21,965,120	(2,660,598,571)
Accumulated net investment income	<u>142,638,819</u>	<u>1,066,782,805</u>	<u>19,770,964,319</u>	<u>20,980,385,943</u>	<u>16,647,077</u>	<u>20,997,033,020</u>
Net position at fair value	<u>\$ 51,487,942</u>	<u>978,196,836</u>	<u>17,268,137,474</u>	<u>18,297,822,252</u>	<u>38,612,197</u>	<u>18,336,434,449</u>

\* 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.

#### Member Systems Money Weighted Returns

Fiscal Year Ended June 30, 2018	7.5	7.5	7.6	n/a	7.6	7.6
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## Illinois State Board of Investment

### Notes to Financial Statements

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#### Note 4. Pensions

##### Plan Description

All ISBI employees participate in the State Employees' Retirement System (SERS), which is a pension trust fund in the State of Illinois reporting entity. The SERS is a single-employer, defined-benefit, public employee retirement system (PERS) in which State employees participate, except those covered by the State Universities, Teachers', General Assembly, and Judges' Retirement Systems. The financial position and results of operations of the SERS for fiscal year 2017 are included in the State of Illinois' Comprehensive Annual Financial Report (CAFR). The SERS also issues a separate CAFR that may be obtained by writing to the SERS, 2101 South Veterans Parkway, P.O. Box 19255, Springfield, IL 62794-9255 or by calling 217/785-7444. The State of Illinois CAFR may be obtained by writing to the State Comptroller's Office, Financial Reporting Department, 325 West Adams Street, Springfield, IL 62704-1858 or by calling 217/782-6000.

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

ISBI also manages the investment related assets of the Illinois Power Agency Trust Fund. The Illinois Power Agency issues a separate Annual Report that may be obtained by writing to the Illinois Power Agency, 160 North LaSalle Street – Suite C-504, Chicago, IL 60601 or by calling 312/814-8106.

##### Funding Policy

ISBI pays employer retirement contributions based upon an actuarially determined percentage of payroll. For fiscal year 2018, the employer contribution rate was 45.598%. ISBI's contributions on behalf of ISBI employees to SERS for fiscal year 2018 was \$666,864 equal to the required contribution.

Effective for pay periods beginning after December 31, 1991, the Board opted to pay the employee portion of retirement for ISBI employees covered by the State Employees' Retirement Systems. Generally, this pickup of employee retirement was part of the budget process and was, in part, a substitute for salary increases. In November 2010 the Board amended the policy to pay the employee portion of retirement to only apply to current employees as of the date of the policy change. New employees from that date forward must pay their own employee portion of retirement contributions. ISBI employee contributions to SERS for the employee portion for fiscal year 2018 was \$24,507.

##### Member System Contributions and Withdrawals

Member systems' contributions are comprised of amounts received directly from the State Employees' Retirement System, General Assembly Retirement System, Judges' Retirement System, and the Illinois Power Agency Trust Fund. The Judges' Retirement System made contributions of \$11,600,000 and the General Assembly Retirement System made contributions of \$700,000 in fiscal year 2018. Member systems' withdrawals are determined by the member retirement systems based on the State's funding, the systems' benefit payment needs and the ability for ISBI to liquidate available assets. The total withdrawals for fiscal year 2018 (including \$1,125,223 by the Illinois Power Agency Trust Fund) were \$313,625,223.

Also, in 2011, proceeds from bonds issued by the State of Illinois were received as contributions. 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

### Notes to Financial Statements

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#### Note 4. Pensions (Continued)

Illinois State Board of Investment the same day. The monies were combined with ISBI's other investments and invested in accordance with the asset allocation policy of ISBI during the year ended June 30, 2011.

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

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

The Governmental Accounting Standards Board (GASB) Statement 75 – Accounting and Financial Reporting for Postemployment Benefits Other Than Pensions became effective for fiscal years beginning after June 15, 2017. This statement requires the allocation Other Post Employment Benefit Plan (OPEB) liability to funds and agencies of the state of Illinois. ISBI is excluded from the allocation requirement because allocations to internal service funds, the State Employees Retirement Pension Trust Fund and the Pension Investment Fund are not considered to be appropriate because the allocation of OPEB costs for these funds must ultimately be recovered through charges to other state funds.

A summary of post-employment benefit provisions, changes in benefit provisions, employee eligibility requirements including eligibility for vesting, and the authority under which benefit provisions are established are included as an integral part of the financial statements of the Department of Central Management Services. A copy of the financial statements of the Department of Central Management Services may be obtained by writing to the Department of Central Management Services, 715 Stratton Building, 401 South Spring Street, Springfield, Illinois 62706-4100.

#### Note 5. New Governmental Accounting Standards

At this time, Management is not aware of any new accounting standards that will impact the financial statement presentation for its year ended June 30, 2019.



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

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

As Special Assistant Auditors for the Auditor General of the State of Illinois, we have audited, in accordance with the auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, the financial statements of the Illinois State Board of Investment (ISBI) and its investment trust funds, the Illinois State Board of Investment Member Systems and the Illinois Power Agency Trust Fund (the Trust Funds) as of and for the year ended June 30, 2018, and the related notes to the financial statements, which collectively comprise ISBI and the Trust Funds' basic financial statements, and have issued our report thereon dated December 12, 2018.

**Internal Control Over Financial Reporting**

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

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be material weaknesses or significant deficiencies and therefore, material weaknesses or significant deficiencies may exist that have not been identified. However, as described in the accompanying schedule of findings and responses, we identified a deficiency in internal control that we consider to be a material weakness.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance. We consider the deficiency described in the accompanying schedule of findings and responses as item 2018-001 to be a material weakness.

**Compliance and Other Matters**

As part of obtaining reasonable assurance about whether ISBI and the Trust Funds' financial statements are free from material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an



opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*

**ISBI and the Trust Funds' Response to Findings**

ISBI and the Trust Funds' response to the finding identified in our audit is described in the accompanying schedule of findings and responses. ISBI and the Trust Funds' response was not subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on the response.

**Purpose of this Report**

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

/s/ KPMG LLP

Chicago, Illinois  
December 12, 2018

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

**Schedule of Findings and Responses**

**Year Ended June 30, 2018**

Current Findings – Government Auditing Standards

**Finding 2018-001 – Inaccurate Financial Reporting**

The Illinois State Board of Investment (ISBI) has not established adequate internal controls over the financial reporting process related to investments.

During our audit of the financial statements as of and for the year ended June 30, 2018, we noted the following:

- For two private equity funds sampled in our testing (totaling \$31,335,419), the fair value of the investments reported was understated by \$1,947,059. Upon further review, we noted ISBI reported preliminary estimated investment values received from the investment manager for these investments and did not have procedures in place to evaluate and update the final fair value amounts reported by the manager (\$33,282,478). In response to the error identified in our audit procedures, ISBI identified nine additional private equity funds under the same investment manager for which an estimated fair value of the investments was reported (totaling \$79,456,829). The final fair value provided by the investment manager for these nine investments totaled \$80,589,143, resulting in an understatement of \$1,132,314. The errors (representing 2.78% of the recorded balance of the investments) were not identified during ISBI's preparation of investment reconciliations or related supervisory procedures. Correcting adjustments were made to the financial statements by ISBI to account for these errors.
- For one bank loan fund sampled in our testing (totaling \$187,206,014), the fair value of the investment reported was overstated by \$160,342. Upon further review, we noted ISBI reported the value of the investment inclusive of the applicable management fees and accrued expenses instead of its fair value (\$187,045,672) at year end. The error (representing .09% of the recorded balance of the investment) was not identified during ISBI's preparation of investment reconciliations or related supervisory procedures. ISBI determined this error was not material to the financial statements and a correcting adjustment was not made to account for this error.

ISBI's private equity investments, bank loan investments, and total investments were \$706,768,270, \$464,315,920, and \$18,320,775,728, respectively, as of June 30, 2018.

Generally accepted accounting principles require investments to be measured at fair value. An investment is a security or other asset that (a) a government holds primarily for the purpose of income or profit and (b) has a present service capacity based solely on its ability to generate cash or to be sold to generate cash. Additionally, the Fiscal Control and Internal Auditing Act (30 ILCS 10/3001) requires ISBI to establish and maintain a system or systems of internal fiscal and administrative controls to ensure: (1) resources are utilized efficiently, effectively and in compliance with applicable law; (2) obligations and costs are in compliance with applicable law; (3) funds, property and other assets and resources are safeguarded against waste, loss, unauthorized use, and misappropriation; (4) revenues, expenditures, and transfers of assets resources, or funds applicable to operations are properly recorded and accounted for to permit the preparation of accounts and reliable financial and

statistical reports and to maintain accountability over the State's resources; and (5) funds held outside the State Treasury are managed, used, and obtained in strict accordance with the terms of their enabling authorities and that no unauthorized funds exist. Effective internal controls should include procedures to accurately record investment values in ISBI's accounting records to allow for the preparation of accurate financial statements.

In discussing these conditions with ISBI officials, they stated the errors identified by the auditors in the first bullet were the result of late reporting by an investment manager for several funds which was not communicated by management when the initial draft was provided. The error reported in the second bullet was the result of an oversight by management.

Failure to accurately report investments may result in the misstatement of the financial statements. (Finding Code 2018-001, 2017-001)

**Recommendation:**

We recommend ISBI review its internal control procedures and implement the changes necessary to ensure investment accounts are accurately reported in its accounting records and in the financial statements. To the extent preliminary or estimated balances are initially reported, ISBI should establish procedures to evaluate, monitor, and update (if necessary) these items when final valuations are received.

**ISBI's Response:**

ISBI agrees with the finding and recommendation. ISBI reviewed its internal control procedures and determined that this error was primarily isolated to a single private equity fund manager (with an immaterial variance identified for a second bank loan fund manager). The total error identified resulted in an overall net understatement of \$2,919,031 or 0.02% of Net Assets. The root cause of the error was the use of final estimated values received instead of the values included on the final capital statements. Additional management review and audit procedures were applied subsequent to the identification of the initial misstatement and outside of the two aforementioned managers, no additional issues were identified. ISBI adjusted its final financial statements to correct the initial understatement related to the private equity funds (\$3,079,373). The overstatement related to the bank loan fund (\$160,342) was not adjusted for due to its immateriality.

Based on the additional audit procedures, management review and the limited scope of the error (isolated primarily to a single private equity fund manager), the existing internal control procedures related to reporting of alternative investments, which include a comparison to values independently determined and reported by our custodian, are generally adequate and result in accurate financial reporting. However, in the future, controls will be enhanced to eliminate the use of estimated values in the quarterly and year-end alternative investment analysis even on a preliminary basis. ISBI will also enhance the additional control related to comparison of final alternative investment values to an independent third- party source in addition to the custodian. Finally, management will proactively communicate with investment managers that have historically provided information late in each reporting cycle and attempt to obtain final capital statements as early in the cycle as possible.