The Advocate

A Publication of the State Universities Retirement System of Illinois

Vol. 14, No. 3

Legislative Update

In addition to Senate Bill 27 (now Public Act 94-4) discussed in the article below, the General Assembly has passed and sent to the Governor three other bills that are of importance to SURS. Senate Bill 23 (now Public Act 94-79), regarding the Republic of the Sudan ("the Sudan"), was signed by the Governor on June 27. Senate Bill 52, regarding private equity investments and the Freedom of Information Act, and HB 1384, establishing a Medicare referendum, passed both houses of the General Assembly and await action by the Governor.

Disinvestment from the Sudan

Public Act 94-79 is the state's response to the horrific acts of genocide occurring in the Sudan. The intent of the legislation is to isolate the Sudanese government and economy and thereby pressure the Sudan to put an end to the genocidal acts. P.A. 94-79, among other actions, creates a list of six types of "forbidden entities" in which Illinois

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State Will Shortchange Pension Funds to Balance Budget

Senate Bill 27 Affects New SURS Participants

At the end of May, the Illinois General Assembly passed and sent Senate Bill (SB) 27 to the Governor which, among other things, will reduce state funding for the five state contributory retirement systems by approximately $1.2 billion during each fiscal year 2006 and 2007. The Governor signed the measure on June 1.

With respect to SURS participants, SB 27 does the following (*these changes do not affect annuitants*). First, it eliminates the SURS "money purchase" formula for all Illinois higher education institution employees first hired after June 30, 2005. Second, it transfers the responsibility for determining the annual interest rate (the "effective rate of interest" or ERI) from the SURS Board of Trustees to the State Comptroller. Third, it shifts from the state to the SURS employers the pension costs that result from employers granting annual compensation increases in excess of 6% in any year that is included in the "final rate of earnings" (FRE) calculation (usually the final four years of employment). Finally, it reduces the state contribution to SURS by nearly $200 million in FY'06 and by nearly $180 million in FY'07.

From an actuarial and system finance perspective, the money purchase formula, interest rate calculation responsibility change, and the 6% limitation cost shift provision have no impact. Since the statutory factors that govern the determination of the ERI remain unchanged and since the data inputs for making that calculation also remain unchanged, the shift of responsibility for determining the rate from the SURS Board to the State Comptroller should not produce any material difference in result. Since the Comptroller will be a fiduciary under state law in the performance of this function, he will have to act solely and exclusively in the interest of the System participants.

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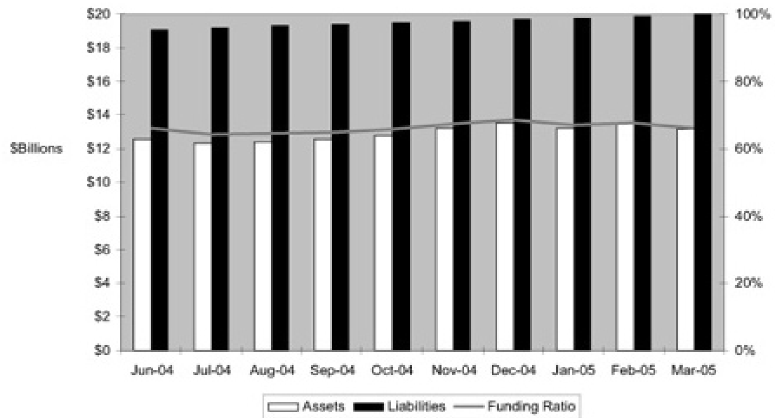
Summer 2005

Investment Update

2005 Fiscal Year-To-Date Investment Results

Fiscal Year-To-Date Results



SURS experienced solid investment results during the first nine months of the fiscal year, posting a net of fee return of 7.8%. This total fund return fell just short of the policy portfolio benchmark return of 8.0%. Equity markets worldwide have been the primary driver of the total fund results. U.S. equity markets, as measured by the Wilshire 5000 Index, have risen 5.8% while international equity markets, as measured by the MSCI All Country World ex-US Index, have increased 16.7% during this same period. Publicly traded real estate investment trusts (REITs) have also provided strong returns, increasing 17.7%, as measured by the Wilshire Real Estate Securities Index.

As of March 31, 2005, SURS's projected funding ratio was 65.9%, virtually unchanged from the funding ratio at the beginning of the fiscal year.

Investment Consultant Search Completed

EnnisKnupp + Associates was selected by the SURS Board of Trustees as the System's general investment consultant at the June 10, 2005, Board meeting. EnnisKnupp + Associates, the incumbent consultant, was retained by the Board after an extensive national search. The search process involved on-site due diligence visits, formal interviews, and reference checks. In addition to EnnisKnupp + Associates, other finalists in the search process were Marquette Associates, New England Pension Consultants, and Summit Strategies.

Manager Development Program Implementation

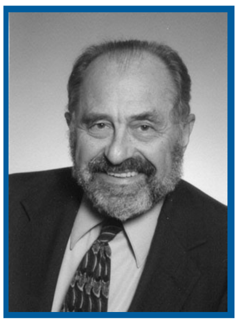
The domestic equity portion of the Manager Development Program has been implemented and eight domestic equity firms have been awarded allocations in the program. The Manager Development Program (MDP) was created by the SURS Board of Trustees in March 2004 in response to the call by the Senate Select Committee on Public Pension Investments to increase the utilization of minority and female-owned investment management firms. The program, which has been allocated $200 million to date, will consist of approximately 12-13 investment assignments across domestic equities, international equities, and fixed income. A fixed income search process will begin this summer with the objective of hiring three fixed income managers by early fall. The search for the minority- and women-owned international equity firms will commence upon the completion of the fixed income search. ❑

Dan Allen is New SURS CIO

At their June 10 meeting, the SURS Board of Trustees selected Dan Allen as Chief Investment Officer for the organization. Dan replaces John Krimmel, who resigned in January of this year to accept the position of Chief Investment Officer at the Kentucky Retirement System. Dan, who joined SURS in 2000, previously served as the Deputy Chief Investment Officer.

Before joining SURS, Dan was employed at Illinois Power Company for over 20 years. He served in various Treasury-related functions for the firm, primarily in the Corporate Finance and Pension areas. Prior to positions in the Illinois Power corporate headquarters in Decatur, he worked at the Clinton Nuclear Power Station.

Dan received an associate degree from Richland Community College, a bachelor degree from Millikin University, and an MBA from the University of Illinois at Springfield. He resides in Decatur with his wife, Karen.❑



A Message From the President

Mitchell Vogel was elected president of the SURS Board of Trustees at their June 10 meeting, replacing Stan Rives, whose term as trustee expired on June 30, 2005. Rives is not seeking reappointment, but will remain on the board until his trustee position is filled. Vogel's term as president began on July 1, 2005. He is a professor emeritus at Northeastern Illinois University and served as president of the University Professionals of Illinois for 16 years. Vogel is also editor-in-chief of *American Academic: A Journal of the American Federation of Teachers*. During his term as president, Vogel will have a regular column in the *Advocate* to address issues that affect SURS participants.

We're Assets, Not Liabilities
By: Mitchell Vogel

"The problem with the pension funds is the existing liability." This statement was uttered recently by a "leading consultant" at a meeting of the SURS Board of Trustees. It took me awhile to realize that when he was saying "liability," he was referring to my earned pension. In his mind, the SURS annuitants' pensions are "liabilities." He cited our longer life span and increased "generous" benefits as reasons for the serious financial problem we are facing.

I have never considered myself a liability. I have also never considered the thousands of retired faculty and staff serviced by the System to be liabilities. We were an asset when we were working and developing a great public higher education system for Illinois, and I consider us an asset now. Of course, the consultant didn't emphasize the principal reason for the pension funding shortfall – the lack of state funding in the 1980's. In fact, if the System had been appropriately funded during that period, SURS would have a substantial surplus today.

Most of the cuts in our system that were recommended by this consultant were not enacted by the state legislature and very few of you will be impacted by those changes. What the legislature did, however, was escalate the future financial crisis by dramatically underfunding the state's contributions for this year and next year. They basically borrowed money from the state's largest pension systems to fund other necessary items in the state's budget.

My purpose in this, my first column of the *Advocate,* is to do three things. First, thank the thousands of you who let the state legislature know your views on the proposed changes in benefits. As stated earlier, you were successful. Your representatives listened and your system is intact.

Second, I want to assure you that the financial instability caused by the lack of appropriate funding is a crisis for Illinois, not the state's pension systems. The Illinois State Constitution Act XIII, Section 5, guarantees that pension benefits will be paid. Therefore, the state has an inviolate responsibility to fund fully earned pensions, regardless of funding levels. It is a state problem, not a SURS problem. Of course, we will do everything we can to solve the problem because we are citizens of the state, directly concerned with its economic and social welfare.

The final purpose of this column is to extend an invitation. I would like to hear from you concerning your pension, the System, or other related issues. I can be reached via email at mvogel@surs.org. Since this is my first month as your board president, I think I will benefit tremendously by hearing from you. ❑

Farewell

Executive Director James Hacking Leaves for Arizona

By: Jim Hacking, Executive Director

After nearly ten years of service at SURS, I have accepted an offer to become the Administrator for the Arizona Public Safety Personnel Retirement System (PSPRS), based in Phoenix. This will be the fourth public employee retirement system where I will have served as the Chief Executive Officer. I am looking forward to the challenges of a new position in a new environment. However, I would like to take this last opportunity to reflect on some of the many events and accomplishments that occurred during my tenure here at SURS.

When I was first recruited for the position of Executive Director in late 1995, the SURS Board had only recently been created. The former SURS Board had been abolished earlier in the year by the General Assembly in reaction to the public disclosure of a variety of inappropriate gifts/reimbursements and – most importantly – the SURS "employee campaign contribution reimbursement scheme." The factors that caused that 1995 scandal were easily and quickly addressed through a strengthening of internal controls, the development of comprehensive policies governing employee/trustee reimbursements, the enhancement of the SURS internal audit function, the creation of an Audit Committee of the Board, and more complete and comprehensive reporting and disclosure to assure that all transactions are subject to ongoing scrutiny, both internally and externally. But these were only the first of many internal changes at SURS.

To improve efficiency and facilitate claim processing, speed transactions, data exchange, and communications, the SURS automated systems were completely reengineered and a variety of websites were created for employers, participants, beneficiaries, and other Illinois "reciprocal" public retirement systems. The Member Services Division of the organization was reorganized to ensure that benefit claims are processed in the most timely manner possible. In addition, a new call center was created and staffed by a dedicated, highly trained, and highly responsive group of counselors.

In 1997, SURS obtained the authorization to implement a new defined contribution plan for new hires as an alternative to our defined benefit plan. In that same legislative session and in exchange for giving up compensable employee sick leave and accepting reduced, state-financed health insurance coverage, SURS achieved significant improvements in the benefits available under its defined benefit plan, including a 2.2% per year benefit formula accrual rate.

In terms of system finance, a statutory change requiring the use of market value of assets, rather than book value, for the SURS financial statements significantly improved the system's funding ratio. In addition, the surging equity markets of the late 1990's enabled SURS to achieve annual rates of return on assets in excess of 10% such that, by June 30th, 2000, the SURS funding ratio was 88.2% – less than 2% away from the state's 1995 statutory funding goal of 90% – and the SURS 10 year average rate of return was in excess of 12%.

Unfortunately, the good news with respect to the System's financial status was not to last. In the last half of FY'00 and through the next two fiscal years, a series of economic contractions, terrorist attacks, and corporate accounting scandals caused a series of major corrections in the U.S. and international equity markets. The value of SURS assets declined sharply and this, coupled with ever-rising liability for present and future benefits, caused the System's funding ratio to sink into the 60% range. In addition, the Illinois state revenue situation deteriorated markedly, making it extremely difficult to provide needed funding for the state entitlement programs – including the state retirement systems – and other budgetary spending priorities.

In 2003, given the rather bleak budgetary situation, the new Administration proposed a $10 billion Pension Obligation Bonding initiative to raise the revenue needed to fund the retirement systems in FY'04 and boost their assets and funding ratios. Given the need to continue to fund the retirement systems in accordance with the 1995 statutory funding program and the continuing refusal of public policy leaders to consider any significant broad-based tax increase, SURS gave its enthusiastic support to the POB initiative, which passed the General Assembly with the constitutionally necessary three-fifths majorities. That kept the state retirement system's funding in line with the statutory requirements for FY'04.

As the FY'05 budget process commenced, the state's economic, revenue, and budgetary situation had not significantly improved. We warned state policymakers of the serious financial consequences that would occur if the state failed to provide the full measure of funding needed to keep the retirement systems in line with the 1995 statutory funding program. But, the option of a partial "pension contribution holiday" was receiving serious consideration. To counter this, we argued that the failure to provide the full amount of funding required by the 1995 funding statute would amount to a relatively expensive form of borrowing, since any funding shortfall would have to be made up in the future with interest at 8.5% compounded through 2045 (which is the end of the 50 year statutory funding program) and that, if borrowing were necessary, it would be better to undertake another POB initiative, since the interest rates then prevailing in the credit markets were far less than 8.5%.

After a protracted budget process that did not end until mid-July, an FY'05 budget was finally agreed upon that provided the full measure of funding for the retirement systems. Thereafter, however, the annual effort to secure full funding for the state retirement systems became even more difficult.

In mid-February of 2005 at the beginning of the FY'06 budget process, the Administration proposed a package of pension benefit reductions and reductions in the state's retirement system funding requirements. At SURS, we pointed out that the proposed benefit changes would encounter extremely strong opposition from the public employee constituencies and their representatives. In addition to the fact that one of these proposals (i.e., the proposed limitation on the rate of interest that can be credited to SURS participant accounts for purposes of the money purchase annuity calculation formula) would adversely impact current SURS participants, it would also violate Art. XIII, Section 5 of the Illinois state constitution (the so-called pension protection clause). In the end, the General Assembly approved SB 27, which reduces some pension benefits for newly hired employees and shifts some pension costs from the state to various public employer entities (primarily school districts and some higher education institutions). However, the bill also reduces state funding for the five state retirement systems by $1.2 billion in both FY'06 and FY'07, with additional reductions in lesser amounts each year thereafter through FY'10.

"As I prepare to take my leave, I can assure all SURS participants and beneficiaries that internally and operationally, all is well."

In terms of SURS, the effect of SB 27 will be a short-term reduction in state funding of $717 million from FY'06 through FY'10, but an additional long-term cost to the state of nearly $3 billion (i.e., a total loss of a potential $2.7 billion in savings that would have resulted from the elimination of the SURS money purchase formula for "new hires" and an additional state contribution requirement of $225.6 million). Thus, the state's public policy response to the FY'06 funding needs of the state retirement systems is to return to the chronic under funding practices of the 1980's that caused the serious pension under funding problem in the first place and gave us a collective unfunded pension liability of over $35 billion – the largest pension funding deficit of any state in the nation.

For the immediate future, no further financial harm is expected to be inflicted on the state retirement systems. However, the under funding problem remains and it is likely to deteriorate further unless policymakers address the state's long-standing structural budget deficit problem – of which the retirement system funding issue is a part. The reality is that normal annual state revenue growth is simply inadequate to meet the rising costs for health care, retirement system, and other entitlement program needs, as well as other budget spending priorities like education.

It is my hope that state policymakers will soon come to the recognition that the structural budget deficit must be addressed through increased revenues from broad-based increases in state income and sales taxes. This can and should be addressed on a bi-partisan basis. All that is required is bi-partisan leadership.

As I prepare to take my leave, I can assure all SURS participants and beneficiaries that internally and operationally, all is well. The system is in the hands of highly qualified and well-trained personnel who have the guidance of a very dedicated and long-serving executive team. The SURS investment program, under the leadership of the Board of Trustees, continues to perform well. It appears that we have followed up the System's FY'04 17% rate of return with an FY'05 rate of return of 9.6%, net of all investment related fees. In addition, the SURS Member Services staff continues to provide the highest quality service in processing claims and providing retirement counseling.

With respect to external matters – and specifically retirement system funding – it is my hope and expectation that for the next two state fiscal years this issue will not generate the kind of controversy it has over the past three. In the meantime, every effort must be made to develop the bipartisan consensus that is needed to address the state's structural budget deficit and with it, the chronically underfinanced condition of the state retirement systems. ❑

Electronic Advocate

To save money on printing costs and fully utilize the advantages of the Internet, SURS members with an email address on file will start receiving the Advocate electronically instead of receiving a paper copy in the mail, beginning with the Fall 2005 issue.When a new issue is added to the website, these members will receive an email notification that the latest Advocate is available for viewing.

Besides the obvious advantage of viewing the Advocate in advance, the online version will have links to more information on the topics discussed, including any applicable forms. If we do not have your current email address on file, visit our Member Website at www.surs.org or call us at 1-800-ASK-SURS. ❑

Legislative Update

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public pension funds cannot invest and from which they must completely divest within 18 months of the effective date of the act, January 26, 2006. The forbidden entities are:

1. The government of the Sudan;
2. Any company controlled by the government of the Sudan;
3. Any company incorporated under the law of the Sudan or whose principal place of business is the Sudan;
4. Any company identified by the U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) as a sponsor of terrorist activities and any company fined, penalized, or sanctioned by OFAC for any violation of U.S. rules and regulations relating to the Sudan after the effective date of the act;
5. Any company identified by an independent researching firm as a company with business activities in the Sudan; and
6. Any non publicly-traded (private equity) company that fails to provide an affidavit to the pension fund's investment manager stating that it does not have business activities in the Sudan.

SURS is examining its investment portfolio carefully, but believes that it has no investments which fall in the first four categories. SURS will use an independent researching firm within the next few months to meet the requirements of the fifth category. Depending upon the results of that review, there could be significant investment costs incurred if SURS must divest from companies held within its low-cost passive index funds.

SURS is also concerned about the feasibility of the sixth category. The sixth category goes beyond the divestment required by the first five categories and requires an affidavit from each company in which SURS's assets are invested by an investment manager. The Sudan is not a place where significant economic growth and venture capital investing is occurring, and SURS, while examining its portfolio carefully, believes that its private equity investments have no business activities in the Sudan. Nevertheless, SURS is informed by its private equity managers that it will be quite difficult to obtain the required affidavits due to the current legal and economic environment in private equity investing. Private equity has been a well-performing asset class for SURS. SURS's private equity return for the 10 years ended December 31, 2004, was 31.3%.

Private Equity and the Freedom of Information Act

This bill provides a welcome clarification of the exemption for portfolio company-level information in a private equity portfolio, while making clear that the private equity manager's financial performance is public and is not exempt.

Medicare Referendum

House Bill 1384 requires SURS to conduct a "referendum" where persons who have been continuously employed by the same employer prior to April 1, 1986, can make an individual election to participate in Medicare. This is a one-time irrevocable election. If a person chose to participate, 1.45% of his or her pay would be deducted and sent to the Social Security Administration. The person's employer would also have to pay 1.45% of the person's pay to the Social Security Administration. If this bill is signed by the Governor, SURS will conduct an educational campaign for those eligible to make this choice. ❑

SB 27 and Budget

(continued from page 1)

At the same time, the SURS Board will still have to calculate the annual rate of interest using the same statutory factors and data inputs as the Comptroller, since the ERI is used for purposes other than the calculation of the money purchase formula (such as the cost to purchase service).

With respect to the 6% limitation provision, no actuarial impact on the System will occur because the actuarial assumption for annual compensation increases for the SURS participant group is only 5.5%. However, on an individual or case-by-case basis, some employers will be charged for the pension cost related to compensation increases in excess of 6% that they grant to employees in any FRE years, unless those excess increases are provided for under contracts entered into, renewed or renegotiated prior to the effective date of SB 27 (i.e., June 1st). Had SB 27 made only the benefit/ERI calculation changes outlined above and left the statutory funding requirements unchanged, the state could have realized a potential long-term saving in terms of SURS contributions of $2.7 billion through FY 2045 (due to the elimination of the money purchase formula for new hires). Unfortunately, SB 27 did make changes to the funding program. The FY'06 state contribution will be reduced, as indicated above, by $200 million and the FY'07 amount will be reduced by $180 million. In addition, the projected state contributions for FY'08 through FY'10 will be reduced in the aggregate by $339 million. Thus, total state contribution reductions spread over the five state fiscal years from FY'06 through FY'10 will total $717 million.

When the benefit/ERI calculation changes are combined with the statutory funding changes, the net result will be a long-term state contribution increase of $225.6 million. Despite a short-term contribution savings for the state of $717 million, the potential long-term saving of $2.7 billion will be entirely lost and, in addition, the state will incur a long-term increase in contributions of $225.6 million. Thus, in order to save $717 million over the next five state fiscal years to facilitate spending for other state budget priorities, the state will incur a long-term cost of nearly $3 billion. ❑

Pre–Retirement Seminars

SURS is offering two pre–retirement seminars at its office in Champaign. These popular one–day seminars cover universal issues related to retirement and financial planning. The information presented will closely follow the format used in past seminars.

The seminars are scheduled for October 8 and November 5. They will be held at SURS, 1901 Fox Drive, Champaign, from 8 A.M. to 3 P.M. Topics will include SURS benefits, legal affairs, and financial planning. The enrollment fee is $20 per member and $10 for a non–member guest. Lunch and refreshments are included in the fee. ❑

Retirement Seminar Application

Do not send any money yet. When your enrollment is accepted, you will be notified of the fee due.

Name	Social Security #
Street	City, State, Zip
Home phone	Work phone
Email address	Date I wish to attend
Anticipated retirement date (doesn't commit you to retiring)	Guest Name

Return to: Karen Maggio, SURS, 1901 Fox Drive, Champaign, IL 61820 or fax to (217) 378-9800