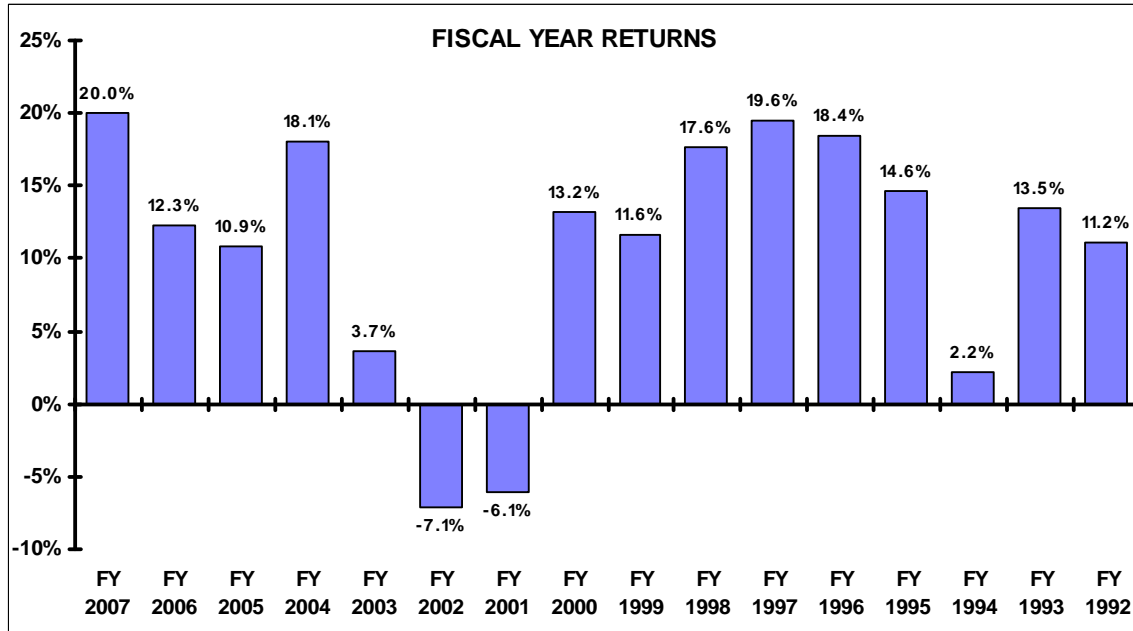


**REPORT ON INVESTMENT ACTIVITY**

Prepared by Robert M. Maynard, Chief Investment Officer

**OVERVIEW OF FISCAL YEAR 2007**

With returns of 20.0%, PERSI had a spectacular fiscal year not only absolutely but also relative to strategic benchmarks, and one that also compares very well to peers. The value of the Fund ended at \$11,462,578,413 -- an increase of \$1.871 billion since June 30 of 2006 from investment returns of \$1.921 billion minus net payments (net benefit payments plus PERSI expenses) of \$50 million. This was PERSI's best fiscal year performance in over 20 years and resulted in a funded status of 105.1% (up from 94.1% at the beginning of the fiscal year) (after COLAs).



The year was also an excellent year compared to strategic benchmarks. If PERSI had been indexed to the strategic benchmark of 55% US Equities (Russell 3000), 15% international (MSCI EAFE), and 30% fixed income (Lehman Aggregate), and had rebalanced at the start of every month, the fiscal year return would have been 16.6%. The additional return of 3.4%, worth over \$300 million, came from four primary sources:

- (1) 1.1% from the strategic dedication of assets to solely emerging market managers,
- (2) 0.7% from simply using global equity managers rather than US only equity managers, and thereby gaining extra return from having a greater exposure to international assets,
- (3) 1.3% from global equity managers collectively outperforming their individual benchmarks (the MSCI World Index), and
- (4) 0.5% from PERSI's internal rebalancing actions over the fiscal year (with the two primary impacts coming from a rebalancing away from REITs in December, and not strictly rebalancing back to fixed income during the year).

All other strategic biases – TIPS, private assets, “traditional” active management, although positive in overall returns, collectively lost slight amounts of money compared to the strategic benchmark returns over the fiscal year.

PERSI's returns compared to peers also ended up very nicely for the year. Callan's public fund database shows PERSI with the best returns in their database for the quarter and in the top 2 percent for the fiscal year. Longer term returns for the last 15 years are almost uniformly in the top decile or top quartile of comparable institutional funds. Of particular interest is that if PERSI had simply met its

◆ Investment Section ◆

strategic returns over the past 10 years, it would have uniformly ranked in the bottom third or fourth quartiles and would have been significantly below average for the last quarter and fiscal year:

**RANKINGS IN THE CALLAN PUBLIC FUND UNIVERSE**  
**June 30, 2007**  
**Percentile Rankings over Period**  
**(1 is highest, 100 is lowest)**

	<b>QTR</b>	<b>1Yr</b>	<b>2Yrs</b>	<b>3Yrs</b>	<b>4Yrs</b>	<b>5Yrs</b>	<b>7Yrs</b>	<b>10Yrs</b>
<b>Return (%)</b>	<b>5.8</b>	<b>20.0</b>	<b>161</b>	<b>14.3</b>	<b>15.2</b>	<b>12.8</b>	<b>6.9</b>	<b>9.0</b>
Policy Return (%)	4.0	16.8	12.7	11.4	12.5	10.6	4.9	7.6
Median Fund (%)	4.3	17.2	13.8	12.6	13.5	11.5	6.7	8.5
<b>PERSI Rank</b>	<b>1</b>	<b>2</b>	<b>9</b>	<b>11</b>	<b>11</b>	<b>14</b>	<b>39</b>	<b>22</b>
<b>Policy Rtn Rank</b>	<b>70</b>	<b>59</b>	<b>72</b>	<b>74</b>	<b>72</b>	<b>74</b>	<b>98</b>	<b>85</b>

The year was led by international equity and particularly emerging markets with returns 47.5% for Bernstein Emerging Markets, 43.6% for Genesis Emerging Markets, 29.6% for Mondrian International Equity, all compared to 27.5% for the MSCI EAFE index and 45.5% for the MSCI Emerging Markets index. Overall, the international portion of PERSI equity assets returned 34.3%.

PERSI's absolute and relative returns were particularly enhanced by the individual and collective activities of the global equity managers – those that can invest assets both domestically and internationally. Global equity managers collectively returned 30.4% for the fiscal year compared to the world equity index returns (MSCI World) of 24.2%. Zesiger Capital once again had an exceptional year with public equity returns of 43.9% and total returns (including private equity) of 42.6% -- 20% more than the benchmark returns. Brandes had a very good year with returns of 30.1%, followed closely by Bernstein Global at 27.9% and Barings at 27.5%. Only Cap Guardian had a sub par year against world index returns with returns of 21.0%, continuing a soft period for them. Fortis was added as a global equity manager only in the last week of the fiscal year.

PERSI's US equity efforts, both public and private, added 19.4%, trailing the R3000 index returns of 20.1% due to a combination of private investments, real estate exposure (public and private), and active manager underperformance. Donald Smith was, once again, the best performing US manager with returns of 26.5%. All other active US managers underperformed the Russell 3000 returns with TCW Domestic (a midcap value manager) at 19.7%, Peregrine (a large cap growth manager) at 18.8%, Mountain Pacific (a mid cap manager) at 18.6%, and Tukman (large cap concentrated) at 17.3%. These returns were generally in line with their particular style benchmark. Adelante started the year with a roar as the REIT market continued its remarkable advance but faded with the REIT markets in the new calendar year to end at 13.4% -- ahead of the REIT index return of 11.5%. Private assets had difficulty keeping up with the very hot public equity markets: private equity had a time-weighted return for the year of 16.9% and private real estate returned 15.7% (equaling or exceeding public REITS for the first fiscal year in some time). The private real estate managers were led by Olympic with returns of 17.8%, followed by Prudential at 16.2%, and Koll at 13.8%, all compared with NCREIF (a private real estate benchmark) returns of 14.9%.

Fixed income had a mediocre year, both absolutely and relatively. The PERSI returns of 5.7% trailed the Lehman Aggregate returns of 6.1%, due primarily to TIPS returns of just over 3% from the SSGA TIPS passive fund (3.6%) and the active TIPS efforts of 3.2% (Bridgewater until November, and Western thereafter). The bright spot for the year in fixed income was the active management of Western Asset Management in their core fixed income account, with returns of 7.6%, and Barings fixed income with returns of 7.2%. Fidelity had benchmark-like returns of 6.2%. The mortgage-oriented accounts generally kept up or slightly exceeded the markets with DBF mortgages returning 6.3% and

## ◆ Investment Section ◆

Clearwater returning 6.2%. The Idaho Commercial Mortgage program had very good relative returns of 7.9% for the fiscal year.

This fiscal year has capped a remarkable recovery since the end of the equity bear market in March of 2003, when the PERSI Fund had dropped to \$5.8 billion (from a previous high of \$7.3 billion in March of 2000). Since then, PERSI has grown to \$11.4 billion with investment gains of \$5.7 billion and a cumulative return of 98% -- almost doubling in size in only a little over 4 years. Much of this, of course, was due to simply good capital markets – PERSI’s strategic allocation (55% US equity, 15% international equity, and 30% US investment grade fixed income) would have returned 77% over this period of time. But extra efforts, almost exclusively from global equity management, emerging markets, REITS, and internal rebalancing, have added over 20% to returns since that time and slightly over \$1 billion to total fund returns. PERSI has been able to consistently add to fund value since March of 1999. Over the past eight years, our strategic and active biases have added over \$2 billion to total fund returns, and, instead of the current \$11.4 billion, the Fund would be hovering around \$9.4 billion in size if only index returns had been gained on the strategic policy allocation.

This fiscal year has capped an even longer turnaround in PERSI fortunes and demonstrates the merits of what is now regarded as a “plain vanilla” approach to institutional investing. This is the investment approach that concentrates on being simple, transparent, and focused: “simple” in the sense of relying primarily on the public markets over time with a 70% equity, 30% fixed exposure; “transparent” in being relatively easy to understand and explain; and “focused” in concentrating on the big issues that will have material impacts on the total portfolio and can be easily managed by a small staff with a citizen board.

PERSI and its approach is rapidly becoming an outlier in the world of institutional investing. The clear trend of the moment is a movement to many smaller, complicated, leveraged, and non-transparent investment styles – hedge funds, infrastructure, commodities, distressed and subprime debt, shorting and market neutral strategies (such as “130/30”) and “portable alpha” structures (which are simply nothing more than leveraged bets on active management) are only a few of the examples. At bottom, these strategies and portfolio structures attempt to rely more on active specific investment bets and less on market returns and the accompanying market volatility. They view the portfolio not as a basic combination of equity and fixed income exposures but instead as “quests for alpha” (returns independent of market returns), based on a group of active risk factors, exposures to “real” assets, inflation assets, growth assets, and the like, with a myriad of specialized strategies. They rely on the ability of boards and staffs to pick the better than average manager who can consistently beat, rather than match, market returns. In that quest, these funds are also willing to give up transparency with easy explainability and instead, embrace the complexity and the much higher fees that come with such activities.

PERSI, on the other hand, has kept to a consistent investment approach over the past 15 years that relies on core exposures to the broader public markets. When active management is used, it is generally through broad mandates with clear or concentrated styles, using no leverage or shorting or forms of “black box” investing, and relying on publicly-traded and priced securities with some private exposure around the public core. PERSI’s approach looks equally, if not more, at keeping control on the liabilities of the System – with contribution rates consistently a bit above normal cost, an achievable hurdle rate of 7.25% net of costs, a requirement of 113% funded status before granting any extra one-time benefits to the constituency, and no long-term medical liability. PERSI has only to make about 3.5% after inflation in order to meet its statutorily guaranteed benefits and around 5% real returns in order to provide full COLAs to its retirees.

With a focus on controlling liabilities as the anchor of its investment program, PERSI can rely on long-term market returns to keep pace with the benefits promised. With a 70%-75% equity and 25%-30% fixed income exposure, market returns alone will be sufficient as long as equities return 4%-5% above inflation over long periods of time (historically they have consistently provided 6%-7% above inflation over 10-20 year periods), and bonds return 2%-3% above inflation. Thus capital markets can provide

## ◆ Investment Section ◆

much lower returns than they have in the past, and PERSI will still easily meet its statutory benefit needs as long as the Fund keeps on track with its program. PERSI does not rely on its active managers for success – active managers are expected to add to value over time, but they are not needed to save the Fund from an otherwise dire situation.

The trade-off is that PERSI will have to accept short-term market volatility to achieve those longer-term returns. PERSI expects a number of years of negative returns on the path to its long-term goal. The negative returns of 2000-2003 should occur at least once every decade, if not slightly more. But PERSI's constituency – the active members, retirees, Legislature, and general public – held firm during the worst equity bear market since the Great Depression in 2000-2003 and demonstrated PERSI's ability to handle expected market volatility.

PERSI thus has about a quarter of its funds in passive or indexed exposures with the bulk of these exposures in the larger, more efficient markets (S&P 500, US investment grade bonds, etc.). Another quarter of PERSI's funds are with traditional active managers – those that have long-only exposures (no short selling) in the normal asset types of US and international developed market equity (large mid and small capitalization stocks with value, growth, or core styles) or primarily investment-grade fixed income. Another quarter of PERSI assets are with global equity managers (who are not confined to either solely US or solely international equity markets). The final quarter of PERSI assets are in private equity (4%), private real estate and Idaho mortgages (6%), dedicated emerging markets mandates (7%), and inflation-protected securities (8%).

These broad but diversified exposures allow PERSI to manage a large amount of money with a small staff, a citizen board, and very tight risk controls. As Warren Buffet noted “risk comes from not knowing what you are doing” – with our type of exposures, it is very easy to see what is happening to the overall PERSI portfolio, to know exactly where we stand in relation to the markets on even a daily basis, and thus not be surprised by unexpected losses or problems building up over time and cascading over material portions of our exposures (as can occur with large, non-transparent, hedge-fund-like investments).

It may be that this relatively straightforward approach is a strategy of the past – but the past has been very, very good to PERSI. Fifteen years ago, PERSI was only \$2.1 billion in size, was 69% funded, the benefit for retirees was only 1.67% of the high five years of salary, and retirees had seen their pensions drop to only 70% of purchasing power. The Fund's returns were at the very bottom (100<sup>th</sup> percentile) of peer group databases, and the Fund had lost \$1 billion since its inception in 1965 compared to simply indexing to the capital markets.

In the past fifteen years, PERSI has grown to well over \$11 billion with less than \$350 million in net contributions to the System, is over 105% funded, has increased the benefit to retirees to 2% of salary of only the high 3.5 years of salary, and has restored full purchasing power to the retirees. Over almost all time periods, PERSI is in the top quartile, and often in or near the top 10<sup>th</sup> percentile, depending on the time period reviewed. PERSI has added over \$2 billion, compared to simply indexing to the capital markets, even after distributing \$155 million to the constituency in one-time gain sharing benefits.

PERSI's “plain vanilla” approach to investing has reaped strong rewards and is in a position where it doesn't have to bet on complicated, leveraged, or non-transparent active management approaches in order to have a strong-funded status. It may be that there is a new era of investing, but PERSI has the luxury of being able to wait for more evidence to accumulate on the new wave's benefits before switching from a tried and proven path.

*For the numbers presented, the source of the above-disclosed data is the Mellon Analytical Solutions reporting system.*

◆◆ Investment Section ◆◆

Investment Summary as of the Year Ended June 30, 2007

<u>Types of Investment</u>	<u>Market Value</u>	<u>Percent of Total Market Value</u>
<b>Short-term investments</b>	\$499,245,160	4.3%
<b>Fixed income</b>		
Domestic	2,468,580,243	21.5%
International	29,858,023	0.3%
Commercial mortgages	<u>282,449,339</u>	<u>2.5%</u>
<b>Total fixed income</b>	2,780,887,605	24.2%
<b>Common stock</b>		
Domestic equity	4,720,991,977	40.9%
International equity	<u>2,688,184,406</u>	<u>23.4%</u>
<b>Total common stock</b>	7,409,176,383	64.4%
<b>Private equity</b>	433,290,555	3.8%
<b>Real estate</b>	<u>383,597,044</u>	<u>3.3%</u>
<b>Total Base Plan investments</b>	<u>\$11,506,196,747</u>	<u>100.0%</u>
<b>Other funds:</b>		
Sick Leave Insurance Reserve Fund	230,843,787	
Choice Plan 414(k)	69,934,126	
Choice Plan 401(k)	<u>224,139,341</u>	
<b>Total investments in all funds</b>	<u>\$12,031,114,001</u>	

◆ Investment Section ◆

**Schedule of Investments by Account as of June 30, 2007  
(including interest and dividends receivable)**

Adelante Capital Management	\$264,436,237
Apollo Management, LP	23,511,528
Baring Asset Management-Global Equity	364,468,383
Baring Asset Management-Global Fixed Income	227,856,801
Bernstein-Emerging Markets	421,084,940
Bernstein-Global Equity	366,663,562
Blackstone Capital Partners, LP	16,530,651
Brandes Investment Partners	689,437,158
Brandes International Equity Fund - <u>Choice Plan</u>	10,836,159
Bridgepoint Capital, LTD	13,501,752
Capital Guardian	439,887,484
Cerberus Investment Partners, LP	10,351,073
Chisholm Management, LP	22,888,541
Clearwater Advisors, LLC	162,646,368
CVC European Equity	16,810,188
D.B. Fitzpatrick & Co.-Fixed Income	167,567,993
D.B. Fitzpatrick & Co.-Idaho Mortgages	289,754,342
Dodge and Cox Income Fund - <u>Choice Plan</u>	3,618,864
Donald Smith & Co.	265,365,237
Dreyfus Prem Midcap Stock Fund - <u>Choice Plan</u>	3,921,011
Enhanced Equity, LP	14,799,861
Fidelity Management Trust Company	216,589,125
First Reserve Fund XI, LP	3,126,774
Fortis Investments	252,866,107
Frazier Technology Ventures II, LP	10,645,428
Furman Selz Investments, LP	6,558,969
Galen Associates, LP	38,880,853
Genesis Asset Managers	418,336,940
Goense Bounds & Partners, LP	6,122,227
Gores Capital Partners, LLP	15,144,620
Green Equity Investors IV, LP	18,056,796
Hamilton Lane Co-Investment Fund, LP	19,443,662
Hamilton Lane Secondary Fund, LP	7,747,513
Harvest Partners III, LP	2,423,205
Highway 12 Ventures, LP	11,407,082
Ida-West	3,275,000
JH Whitney & Co., LLC	11,433,092
KKR 2006 Fund, LP	3,956,633
Kohlberg & Co.	17,155,926
Koll Partners, LLP	256,234,682
Lindsay Goldberg & Bessemer	9,711,331
Littlejohn, LP	12,687,592

(Continued)

◆ Investment Section ◆

McCown DeLeeuw & Co. IV, LP	3,056,316
Mellon Aggregate Bond Index - <u>Choice Plan</u>	1,398,523
Mellon Capital Management-R2000 Small Cap	149,829,466
Mellon Capital Management-S&P 500 Large Cap	1,374,868,160
Mellon Capital Management-Mid Cap Completion	219,025,786
Mellon Capital Management-International Stock Index	542,171,977
Mellon International EAFE Fund - <u>Choice Plan</u>	3,445,686
Mellon S&P 500 - <u>Choice Plan</u>	6,959,283
Mellon Transition Management Services	154,605
Mellon Wilshire 5000 - <u>Choice Plan</u>	1,929,995
Mondrian Investment Partners	377,179,782
Mountain Pacific Investment Advisors	358,533,837
Newbridge Asia, LP	16,177,459
Oaktree Capital Management, LLC	1,954,559
Olympic IDA Fund II, LLC	86,565,611
Pareto Partners	(2,334,686)
Peregrine Capital Management	193,827,287
PERSI Cash in Short-Term Investment Pool	15,049,639
PERSI Choice Plan Contribution Holding Account	1,127,975
PERSI Choice Plan Loan Fund	2,183,234
Providence Equity Partners, LLP	47,943,344
Prudential Investments	48,860,030
Rowe Price International	2,167,077
Rowe Price Small Cap Fund - <u>Choice Plan</u>	6,837,928
SEI Stable Asset Fund - <u>Choice Plan</u>	9,094,219
State Street Global Advisors-Fixed Income	578,353,199
State Street Global Advisors-TIPS	644,470,129
State Street Global Advisors-Sick Leave Insurance Reserve	230,843,787
T3 Partners, LP	41,847,463
TCW Domestic	214,239,305
Thomas H. Lee, LP	2,643,600
Tukman Capital Management	332,417,978
Vanguard Growth & Income Fund - <u>Choice Plan</u>	8,795,202
W. Capital Partners, LP	12,572,801
Western Asset Management	219,468,697
Western Asset - TIPS	265,315,976
Zesiger Capital Group	583,906,806
Zesiger Capital Group-Private Equity	12,946,555
	<hr/>
Total market value, including investment receivables and payables	\$11,753,570,280
Add: Investments purchased payable	1,425,333,383
Less: Investments sold receivable	(1,103,979,386)
Less: Interest and dividends receivable	(43,810,276)
	<hr/>
Total market value, net of investment receivables and payables	<u>\$12,031,114,001</u>

(Concluded)

## Investment Section

### Investment Results (Defined Benefit Plans Only)

MANAGERS	TOTAL MKT VAL (MILLIONS)	% OF TOTAL FUND	Investment Performance for Periods Ending			
			FISCAL	1 YR	3 YRS*	5 YRS*
<b>U.S. EQUITY</b>						
MELLON CAPITAL MANAGEMENT MID CAP	\$219.0	1.9%	20.6%	20.6%	16.6%	16.0%
MELLON CAPITAL MANAGEMENT R2000 SMALL CAP	149.8	1.3	16.2	16.2	13.2	13.6
MELLON CAPITAL MANAGEMENT S&P 500 LC	1,374.9	12.0	20.5	20.5	11.6	10.6
MOUNTAIN PACIFIC	358.5	3.1	18.6	18.6	12.6	11.4
TUKMAN CAPITAL MGMT	332.4	2.9	17.3	17.3	5.3	5.5
TCW	214.2	1.9	19.7	19.7	11.8	
DONALD SMITH & CO.	265.4	2.3	26.5	26.5	19.0	
PEREGRINE	193.8	1.7	18.8	18.8		
TOTAL U.S. PUBLICLY TRADED EQUITY	\$3,108.1	27.1%	20.0%	20.0%	11.8%	10.9%
BENCHMARK - Russell 3000			20.1%	20.1%	12.4%	11.5%
<b>PRIVATE EQUITY</b>						
IDA-WEST	\$3.3	0.0	20.6%	20.6%	26.6%	36.1%
GALEN III	38.9	0.3	37.4	37.4	5.4	5.4
HARVEST PARTNERS	2.4	0.0	(65.0)	(65.0)	(34.1)	(28.4)
FURMAN SELZ	6.6	0.1	28.6	28.6	40.4	36.9
MCCOWN DE LEEUW	3.1	0.0	22.9	22.9	(73.1)	(55.4)
PROVIDENCE EQ PARTNERS	47.9	0.4	19.1	19.1	33.7	43.7
CHISOLM PARTNERS	22.9	0.2	24.1	24.1	22.7	8.9
LITTLEJOHN II L.P.	12.7	0.1	97.8	97.8	74.6	26.4
OAKTREE CAP	2.0	0.0	230.0	230.0	57.3	40.5
GOENSE BOUNDS	6.1	0.1	7.8	7.8	15.5	44.6
HWY 12 FD VENTURE LP	11.4	0.1	(6.4)	(6.4)	2.2	(7.6)
T3 PARTNERS II L.P.	41.8	0.4	20.7	20.7	36.2	254.8
THOMAS LEE L.P.	2.6	0.0	(11.0)	(11.0)	3.5	(4.2)
APOLLO MGMT LP	23.5	0.2	22.8	22.8	48.0	37.3
GREEN EQUITY IV L.P.	18.1	0.2	9.7	9.7	16.0	
GORES CAPITAL AD LLC	15.1	0.1	37.3	37.3	9.0	
W CAPITAL PARTNERS	12.6	0.1	3.1	3.1	1.2	
FRAZIER TECH VENTURES II	10.6	0.1	18.0	18.0	(0.2)	
KOHLBERG & CO.	17.2	0.1	3.4	3.4		
HAMILTON SECONDARY	7.7	0.1	14.6	14.6		
CVC EUROPEAN EQUITY	16.8	0.1	57.2	57.2		
HAMILTON LANE CO-INVESTMENT FUND	19.4	0.2	0.2	0.2		
BRIDGEPOINT EUROPE III	13.5	0.1	(0.6)	(0.6)		
NEWBRIDGE ASIA LP	16.2	0.1	5.6	5.6		
JH WHITNEY EQUITY PARTNERS IV	11.4	0.1	22.6	22.6		
BLACKSTONE CAPITAL PARTNERS	16.5	0.1	3.7	3.7		
ENHANCED EQUITY FUND LP	14.8	0.1	(16.3)	(16.3)		
LINDSAY GOLDBERG & BESSEMER II**	9.7	0.1				
KKR 2006 FUND**	4.0	0.0				
FIRST RESERVE FUND XI**	3.1	0.0				
CERBERUS INSTITUTIONAL PARTNERS**	10.4	0.1				
ZESIGER CAPITAL GROUP	12.9	0.1	0.6	0.6	6.6	(3.1)
TOTAL PRIVATE EQUITY	\$455.3	4.0%	16.9%	16.9%	20.0%	13.4%
<b>REAL ESTATE</b>						
KOLL PARTNERS	\$256.2	2.2%	13.8%	13.8%	6.9%	
OLYMPIC IDA FUND II	86.6	0.8	17.8	17.8		
ADELANTE - PUBLIC R/E	264.4	2.3	13.4	13.4	24.3	22.1%
PRUDENTIAL	48.9	0.4	16.2	16.2	18.6	15.2
TOTAL R/E MANAGERS	\$556.1	5.7%	18.2%	18.2%	23.1%	20.8%
BENCHMARK - NCREIF			14.9%	14.9%	17.4%	13.7%
TOTAL U.S. EQUITY	\$4,219.5	36.7%	19.4%	19.4%	13.6%	12.1%
BENCHMARK - Russell 3000			20.1%	20.1%	12.4%	11.5%
<b>GLOBAL EQUITY</b>						
BARING ASSET MANAGEMENT	\$364.5	3.2%	27.5%	27.5%	16.9%	14.2%
BRANDES INVST PARTNERS	689.4	6.0	30.1	30.1	19.1	18.7
CAPITAL GUARDIAN	439.9	3.8	21.0	21.0	15.5	14.7
ZESIGER CAPITAL GROUP	583.9	5.1	43.9	43.9	29.5	26.1
BERNSTEIN GLOBAL	366.7	3.2	27.9	27.9	23.5	
FORTIS INVESTMENTS**	252.9	2.2				
TOTAL GLOBAL EQUITY	\$2,697.2	23.5%	30.4%	30.4%	20.7%	18.2%

(Continued)



 **Investment Section** 

**Investment Results (Defined Benefit Plans Only)**

MANAGERS	TOTAL MKT VAL (MILLIONS)	% OF TOTAL FUND	Investment Performance for Periods Ending			
			FISCAL	1 YR	3 YRS. *	5 YRS. *
TOTAL U.S./GLOBAL EQUITY	\$6,916.7	60.2%	23.2%	23.2%	15.9%	14.1%
BENCHMARK - Russell 3000			20.1%	20.1%	12.4%	11.5%
<b>INTERNATIONAL EQUITY</b>						
GENESIS INVESTMENTS	\$418.3	3.6%	43.6%	43.6%	39.3%	33.1%
MELLON CAPITAL MANAGEMENT INTL STK INDX	542.2	4.7	26.5	26.5	21.9	17.6
T. ROWE PRICE	2.2	0.0	32.5	32.5	22.1	16.3
MONDRIAN	377.2	3.3	29.6	29.6	24.5	
BERNSTEIN EMERGING	421.1	3.7	47.5	47.5	43.1	
TOTAL INTERNATIONAL EQUITY	\$1,760.9	15.4%	34.5%	34.5%	27.1%	20.8%
TOTAL INT'L EQUITY (HEDGED) <sup>1</sup>	\$1,758.6	15.3%	34.3%	34.3%	26.9%	20.4%
EAFE INDEX NET			27.5%	27.5%	22.7%	18.2%
TOTAL EQUITY	\$8,675.4	75.6%	25.6%	25.6%	18.2%	15.4%
BENCHMARK - Russell 3000			20.1%	20.1%	12.4%	11.5%
<b>U.S. FIXED INCOME</b>						
DBF & CO FIXED	\$167.6	1.5%	6.3%	6.3%	4.0%	4.1%
DBF & CO-IDAHO MTGS	289.8	2.5	7.9	7.9	4.8	4.9
STATE ST ADV-FX	578.4	5.0	6.1	6.1	3.9	4.7
SSGA-TIPS	644.5	5.6	3.6	3.6	4.1	6.6
CLEARWATER-TBA	162.6	1.4	6.2	6.2	4.0	4.1
TOTAL U.S. FIXED INCOME	\$1,842.8	16.1%	5.6%	5.6%	4.1%	5.5%
<b>GLOBAL FIXED INCOME</b>						
BARING ASSET MANAGEMENT	\$227.9	2.0%	7.2%	7.2%	4.6%	5.3%
FIDELITY	216.6	1.9	6.2	6.2		
WESTERN ASSET	219.5	1.9	7.6	7.6		
WESTERN-TIPS**	265.3	2.3				
TOTAL GLOBAL FIXED INCOME	\$929.2	5.8%	5.9%	5.9%	4.4%	4.7%
TOTAL FIXED INCOME	\$2,772.0	24.2%	5.7%	5.7%	4.2%	5.4%
BENCHMARK - LB Aggregate			6.1%	6.1%	4.0%	4.5%
<b>OTHER</b>						
UNALLOCATED CASH	\$15.0	0.2%	15.3%	15.3%	9.8%	8.1%
MELLON TRANSITION MANAGEMENT SERVICES	0.2	0.0	133.7	133.7	206.7	
TOTAL OTHER	\$15.2					
<b>COMBINED TOTAL</b>	<b>\$11,462.6</b>	<b>100.0%</b>	<b>20.0%</b>	<b>20.0%</b>	<b>14.3%</b>	<b>12.8%</b>
BENCHMARK - 55% Russell 3000			16.8%	16.8%	11.4%	10.6%
30% Lehman Aggregate						
15% MSCI EAFE Index						
Add: Mutual Fund Holdings in 401(K) Plan	\$60.1					
Sick Leave Fixed Income Investments	86.6					
Sick Leave Equity Securities	144.3					
Investments Purchased	1,425.3					
Less: Interest and Dividends Receivable	(43.8)					
Investments Sold	(1,104.0)					
<b>Total Pension Fund Investments</b>						
<b>Net of Receivables</b>	<b>\$12,031.1</b>					

\*Rates of Return are annualized

<sup>1</sup>Includes Pareto Partners currency overlay account

\*\*Accounts opened less than one year

Prepared using a time-weighted rate of return per Mellon Analytical Solutions-a division of Mellon Global Security Services.

(Concluded)

◆ Investment Section ◆

**Schedule of Investment Income for the Last Six Years**

<u>Year</u>	<u>Interest</u>	<u>Dividends</u>	<u>Gains &amp; Losses*</u>	<u>Total</u>
2002	\$120,190,309	\$ 68,412,290	\$ (663,804,822)	\$(475,202,223)
2003	107,626,722	82,726,663	47,095,088	237,448,473
2004	105,106,092	99,565,950	1,005,291,439	1,209,963,481
2005	108,964,781	121,363,908	622,839,336	853,168,025
2006	128,071,925	135,998,068	804,450,498	1,068,520,491
2007	152,332,222	150,190,103	1,660,923,284	1,963,445,609

\* Includes realized and unrealized gains and losses and other investment income

**List of Largest Assets Held**

**Largest Bond Holdings (by Market Value) June 30, 2007**

	<u>Par</u>	<u>Bonds</u>	<u>Description</u>	<u>Market Value</u>
1	\$221,035,536	US TREASURY INFLATION INDEX BD	3.875% 04/15/2029 DD 04/15/99	\$266,865,928
2	225,145,008	US TREASURY INFLATION INDEX NT	4.250% 01/15/2010 DD 01/15/00	233,675,978
3	174,837,188	US TREASURY INFLATION INDEX BD	2.000% 01/15/2026 DD 01/15/06	158,364,203
4	46,190,000	COMMIT TO PUR FNMA SF MTG	5.500% 07/01/2037 DD 07/01/07	44,544,481
5	45,999,070	US TREASURY INFLATION INDEX BD	2.375% 01/15/2025 DD 07/01/04	44,230,957
6	41,250,000	COMMIT TO PUR FNMA SF MTG	6.000% 08/01/2022 DD 08/01/07	41,417,558
7	41,000,000	COMMIT TO PUR FHLMC GOLD SFM	5.000% 08/01/2037 DD 08/01/07	38,411,875
8	35,000,000	COMMIT TO PUR FNMA SF MTG	5.500% 08/01/2037 DD 08/01/07	33,731,250
9	32,300,000	COMMIT TO PUR FNMA SF MTG	6.000% 07/01/2037 DD 07/01/07	31,946,703
10	31,154,000	US TREASURY NOTES	5.125% 05/15/2016 DD 05/15/06	31,329,241

**Largest Stock Holdings (by Market Value) June 30, 2007**

	<u>Shares</u>	<u>Stock</u>	<u>Market Value</u>
1	2,291,292	GENERAL ELECTRIC CO.	\$ 87,710,658
2	2,377,493	MICROSOFT CORP.	70,064,719
3	921,716	AMERICAN INTERNATIONAL GROUP, INC.	64,547,771
4	595,577	IBM CORP.	62,684,479
5	952,018	JOHNSON & JOHNSON CO.	58,663,349
6	249,506	GOLDMAN SACHS GROUP, INC.	54,080,426
7	637,922	EXXON MOBIL CORP.	53,508,897
8	1,354,249	WELLS FARGO & CO.	47,628,937
9	1,801,519	PFIZER, INC.	46,064,841
10	68,748	SAMSUNG ELECTRONICS CO. LTD.	42,116,420

A complete list of portfolio holdings is available upon request.

◆ Investment Section ◆

**Schedules of Fees and Commissions for the Year Ended June 30, 2007**

<u>Investment fees by type</u>	<u>Average assets under management</u>	<u>Fees</u>	<u>Basis points</u>
Investment manager fees			
Equity managers	\$7,465,528,230	\$26,504,321	36
Fixed income managers	2,374,730,097	1,910,955	8
Private equity managers	632,324,349	7,420,484	117
Real estate managers	610,154,014	4,270,592	70
	<hr/>		
Total average assets	\$11,082,738,690		
Total investment manager fees		40,106,352	36
Other investment service fees			
Custodian/recordkeeping fees		4,763,655	
Investment consultant fees		1,937,959	
Legal fees		1,183,280	
Actuary/audit service fees		411,881	
		<hr/>	
Total investment service fees		8,296,775	7
Total defined benefit plans' fees		\$48,403,127	<u>44</u>
Total defined contribution plans' fees		237,544	
Total other trust funds' fees		116,726	
		<hr/>	
<b>Total investment fees</b>		<b>\$48,757,397</b>	

(Continued)

◆ Investment Section ◆

**Schedules of Fees and Commissions for the Year Ended June 30, 2007**

<u>Broker Commissions</u>	<u>Base Commission</u>	<u>Total Shares</u>	<u>Commission per Share</u>
DEUTSCHE BK SECS INC, NY	\$ 431,070	294,983,411	0.0115
BEAR STEARNS & CO INC, NEW YORK	185,136	9,200,546	0.0201
LEHMAN BROS INC, NEW YORK	177,444	4,587,407	0.0387
GOLDMAN SACHS & CO, NEW YORK	167,660	13,129,153	0.0128
MORGAN STANLEY & CO INC, NEW YORK	124,497	9,124,095	0.0136
JEFFERIES & CO INC, NEW YORK	124,216	2,872,182	0.0432
CITIGROUP GBL MKTS LTD, LONDON	120,698	7,519,526	0.0161
CITIGROUP GBL MKTS/SALOMON, NEW YORK	119,453	44,945,118	0.0027
DEUTSCHE BK INTL EQ, LONDON	117,580	4,277,860	0.0275
BEAR STEARNS SEC CORP, BROOKLYN	117,263	4,909,501	0.0239
LEHMAN BROS INTL, LONDON	108,587	9,145,641	0.0119
UBS SECURITIES LLC, STAMFORD	100,292	3,712,189	0.0270
MERRILL LYNCH INTL LONDON EQUITIES	97,209	3,025,428	0.0321
CITIGROUP GBL MKTS INC, NEW YORK	96,824	3,028,633	0.0320
INVESTMENT TECHNOLOGY GROUPS, NEW YORK	96,148	8,509,759	0.0113
CREDIT LYONNAIS SECS (ASIA), HONG KONG	94,825	21,813,200	0.0043
GOLDMAN SACHS INTL, LONDON	92,519	4,561,415	0.0203
MERRILL LYNCH PIERCE FENNER, WILMINGTON	87,182	20,691,484	0.0042
BERNSTEIN SANFORD C & CO, NEW YORK	86,299	1,967,412	0.0439
MERRILL LYNCH PIERCE FENNER SMITH INC, NEW YORK	85,907	2,740,011	0.0314
CITATION GROUP, NEW YORK	79,042	1,961,091	0.0403
J P MORGAN SECS LTD, LONDON	75,011	2,585,496	0.0290
CANTOR FITZGERALD & CO INC, NEW YORK	73,968	1,923,229	0.0385
UBS WARBURG ASIA LTD, HONG KONG	71,784	12,252,900	0.0059
MORGAN STANLEY & CO, LONDON	70,816	3,668,294	0.0193
UBS EQUITIES, LONDON	70,613	1,829,047	0.0386
CREDIT SUISSE, NEW YORK	66,173	2,632,364	0.0251
CREDIT SUISSE (EUROPE), LONDON	64,154	2,238,681	0.0287
INSTINET CORP, NEW YORK	63,510	1,659,309	0.0383
CREDIT SUISSE (HK) LIMITED, HONG KONG	57,016	11,994,261	0.0048
ABEL NOSER CORP, NEW YORK	55,875	3,306,950	0.0169
DEUTSCHE SEC ASIA LTD, HONG KONG	55,400	31,283,870	0.0018
CJS SECURITIES, BROOKLYN	53,066	1,550,458	0.0342
OTHER BROKERS UNDER \$60,000	2,121,225	212,761,365	0.0100
<b>TOTAL BROKER COMMISSIONS</b>	<b>\$5,608,462</b>	<b>766,391,286</b>	<b>0.0073</b>

A complete list of broker commissions is available from PERSI. PERSI does not require that investment managers use specific brokers.

(Concluded)

## **STATEMENT OF INVESTMENT POLICY AND GUIDELINES**

### **I. Introduction**

The Retirement Board of the Public Employee Retirement System of Idaho (“the Board”)(“the System”) hereby establishes its Statement of Investment Policy for the investment of the trust funds (“the Trust”) in accord with Idaho Code Chapter 13, Title 59.

### **II. Statutory Requirements**

The investment of the Trust will be in accord with all applicable laws of the State of Idaho.

#### **A. Sole Interest of Beneficiaries**

Investments will be solely in the interest of the participants and beneficiaries and for the exclusive purpose of providing benefits to the participants and their beneficiaries and defraying reasonable expenses of administration.

#### **B. Prudent Investments**

Investments will be made with the judgment and care under the circumstances then prevailing, which people of prudence, discretion and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable outcome as well as the probable safety of their capital. Investments will be diversified so as to minimize the risk of loss and to maximize the rate of return, unless under the circumstances it is clearly prudent not to do so.

#### **C. Fiduciary Duties**

The Board and its agents, including staff, consultants, and investment managers, will discharge their duties with respect to the fund solely in the interest of the members and retired employees, and with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.

### **III. Investment Goals**

#### **A. General Objective**

##### **1. Purpose**

The purpose of the investment of Trust assets is to provide funds to meet the obligations of the Public Employee Retirement System of Idaho (PERSI) while incurring the appropriate amount of risk consistent with attaining that goal. The Board will invest the assets of the Trust so as to meet the projected obligations of the System, and will reduce risk through diversification of the assets of the Trust.

##### **2. Considerations**

In determining the returns needed by the system, the acceptable risk levels, and the allowable investments, the Board will consider:

- \* The effect of particular investments on the total portfolio,
- \* The purpose of the plan,
- \* The diversification of the portfolio,
- \* Liquidity needs and the current return relative to the anticipated cash flow requirements, and
- \* The projected return of the portfolio as it relates to the funding objectives of the plan.

#### **B. Specific PERSI return and risk objectives**

##### **1. Investment Returns**

###### **(a) Actuarial Assumptions**

In projecting obligations and the returns needed to meet those obligations, the Board will consider studies performed by actuaries hired by the Board. The actuary uses an investment return assumption of 8% before fees and expenses in balancing projected obligations, projected contributions, and projected returns on assets. Assuming all of the actuarial assumptions are accurate, this 8% return will suffice to: (1) assure the payment of statutorily required benefits, which includes a 1% Cost of Living Adjustment (COLA); and (2) maintain the reduction of the level of the unfunded liability (if any) on the scheduled amortization (one year at a time). The assumed 8% return will not be sufficient to fund either

discretionary COLAs (2-6%), retroactive COLAs, accelerate the amortization of the unfunded liability, build a stabilization reserve, or allow for gain-sharing distributions.

**(b) Inflation and Salary Assumptions**

This 8% rate assumes an inflation rate of 4.25% and an annual general state salary growth of 5.25%. To the extent that either inflation or salary growth are higher or lower than these rates, then the investment returns needed will also be higher or lower than the assumed 8%, although not on a 1:1 ratio. Consequently, the investment returns actually needed by the system do not have a nominal rate which can be determined with precision in advance -- the 8% rate currently used by the actuary is only a general midpoint accurate over long (15-20) year periods and is only as accurate as are the inflation and salary assumptions.

**(c) Relation to Funding Policy**

As set out in the Board's funding policy, to the extent investment markets allow, it is the desire of the Board to provide discretionary COLAs, accelerate the amortization of any unfunded liability, and provide for gain-sharing. It is also the goal of the Board to maintain a reasonable amortization of any unfunded liability, and not to exceed the 25 year amortization period set by statute. Therefore, it is the goal of the Board to set an expected rate of return above the actuarially assumed return so that (1) discretionary COLAs will have a reasonable chance of being consistently funded and (2) the scheduled amortization of any unfunded liability is not unreasonably jeopardized. Returns above that amount will be used to build a stabilization reserve and to distribute to the System participants through gain-sharing.

**(d) Periodic Specific Return Goals**

Because of the inflation sensitivity of both the returns needed by the system and the size of annual COLAs, an exact target return (either real or nominal) cannot be set in advance. Nonetheless, under most reasonable actuarial assumptions, PERSI has a relatively stable real return goal of between 4.75% - 5.25% if consistent funding of discretionary COLAs and providing for gain sharing is included as an objective. Consequently, specific return goals for upcoming periods will be set out in the strategic asset allocations periodically adopted by the Board.

**2. Investment Risk and Strategic Asset Allocations**

**(a) Diversification Among Asset Classes**

In controlling the risk level that is appropriate for the Trust, the Board will diversify the assets of the Trust among various asset classes as the Board may from time to time adopt as appropriate asset classes. The specific asset classes to be used will be set in conjunction with the strategic asset allocation adopted from time to time by the Board.

**(b) Review of Asset Classes and Asset Allocation**

In setting strategic allocations, the Board will focus on assuring that the expected long-term returns will meet expected long-term obligations with the appropriate level of risk sufficient to meet those objectives. The Board will at least once every four years determine the appropriate asset classes for the investment of Trust assets and conduct asset allocation studies to help determine the long term strategic allocations among desired asset classes so as to meet long-term return objectives with the appropriate level of risk.

**(c) Content of Strategic Asset Allocations**

The strategic asset allocation will set out the asset classes to be used, the long-term strategic "normal" percentage of assets to be invested in each asset class, the short to intermediate term ranges that will be considered allowable temporary deviations from the strategic normal allocation, the investment risk and return expectations for each asset class, the numerical investment return and risk expected to be realized, and the relation of the expected investment return to the real and actuarially assumed investment return.

**(d) Strategic Policies**

In addition to asset allocation, the Board may from time to time adopt strategic policies. "Strategic policies" are actions by the Board to invest in asset types that have not been singled out as "asset classes" in the asset allocation process, to overweight particular sectors within an asset class, or to

employ particular strategies in the investment of Trust assets. The purposes of these actions are either to increase the return above the expected return or to reduce risk. Examples of types of strategic policies include: a tilt towards small capitalization stocks in U.S. equity allocations; a tilt toward mortgage exposures in fixed income; hedging international currency exposures through a currency overlay program, and adding international emerging markets exposure in international equities.

#### **IV. Investment Structure**

##### **A. Overall Structure**

In making individual investment policy decisions, the Board will have as an overall goal a flexible, simplified structure with clear roles and accountability.

##### **1. Board Ultimately Responsible**

The Board is ultimately responsible for all investment activities. In exercising this responsibility, the Board will hire investment personnel and agents and delegate various investment functions to those personnel and agents. Where the Board does not delegate investment powers or duties, the Board will either satisfy itself that it is familiar with such matters, or will retain persons who are familiar with such matters to consult or assist the Board in the exercise of those responsibilities. Where the Board delegates a responsibility, it will be delegated to a person who is familiar with such matters, and the Board will monitor and review the actions of those to whom responsibilities are delegated.

##### **2. General Roles and Responsibilities of Board and Agents**

The Board will favor a structure that accommodates a citizen Board and a small staff. The Board and staff will concentrate their activities on:

- \* Strategic decisions, primarily concerning asset allocation and strategic policies;
- \* Adjusting the mix between passive and active managers depending on, among other considerations, near-term concerns regarding the U.S. and other capital markets; and
- \* Delegating and monitoring all other activities, including hiring and monitoring investment managers.

The Board will rely on outside agents, and primarily investment managers, to be responsible for non-strategic decisions. This responsibility includes those investment decisions with shorter-term consequences such as the best near-term securities, regions, asset types, or asset classes.

##### **B. Direct (Non-Delegated) Responsibilities of the Board**

###### **1. Specific Responsibilities**

The Board will be directly responsible for

- \* Setting investment policy,
- \* Determining the investment structure of the Trust,
- \* Determining the asset classes to be utilized,
- \* Setting the strategic asset allocation,
- \* Determining strategic policies;
- \* Hiring agents to implement the strategic asset allocation;
- \* Hiring agents to implement strategic policies; and
- \* Monitoring the compliance of those agents with the investment policies and strategic allocations set by the Board.

###### **2. Delegation and Monitoring of Specific Investment Activities**

The Board will normally delegate investment decisions concerning specific securities or assets, or the tactical allocations of assets among asset types, to outside agents. The Board will retain direct responsibility for the monitoring of the activities of those agents through periodic reports from its staff or consultants. The Board may choose to exercise direct investment responsibility if unusual market conditions or other circumstances so indicate.

##### **C. Employees, Consultants, and Advisors to the Board**

###### **1. Investment Staff**

###### **(a) Duties of Chief Investment Officer and Other Staff**

The Board will hire a Chief Investment Officer and such other staff as it considers appropriate who will

## ◆ Investment Section ◆

be generally responsible for the oversight of the investment of Trust assets, and, as part of that overall responsibility, will: (1) supervise, monitor, and evaluate the performance of the investment managers hired by the Board to assure compliance with investment policy and individual guidelines; (2) assist the Board in developing and adjusting investment policy, including reviewing and modifying the asset allocation as conditions warrant; (3) research current market conditions, evaluate new products, and seek out new approaches to improve portfolio return, reduce risk, and reduce costs and fees; (4) work with the consultants, custodians, investment managers, and other agents in the performance of their assigned duties; and (5) assist the Board with education and other efforts to promote good decision making. Except in special circumstances, PERSI staff will not be responsible for the investment, purchase, or sale of specific assets.

### **(b) Allocation of New Net Contributions**

The Chief Investment Officer shall allocate new net contributions to or withdraw net distributions from the system among investment managers in accordance with the strategic and tactical ranges established by the Board in the strategic asset allocation. The Chief Investment Officer shall report to the Board regularly on the allocation of new net contributions or the withdrawal of net distributions.

### **(c) Tactical Asset Allocation**

With prior notice to the Board, the Chief Investment Officer may shift assets among managers (including between passive and active managers) as long as the asset allocation is maintained within the strategic ranges. If conditions do not permit giving prior Board notice, the Chief Investment Officer is authorized to move assets among investment managers within the strategic ranges established by the Board. If such action is taken, the Chief Investment Officer shall notify the Chairman of the Board as soon as is practical either that action is contemplated or has been taken, as circumstances warrant.

### **(d) Minimum Qualifications of Chief Investment Officer**

The Chief Investment Officer shall at least: (a) have a graduate degree in finance, law, business administration, or a related field, or (b) be a Chartered Financial Analyst; or (c) have three or more years experience in the investment of trust assets.

## **2. Actuaries**

The Board will hire an actuary to provide studies that will: (1) determine the long term obligations faced by the System through annual actuarial valuations, (2) set out return objectives or assumptions that will be sufficient to meet those obligations; and (3) provide reviews at least once every four years of the actuarial valuation process, including updating the projections and assumptions in light of the experience of the System. The Board will set its long-term return objectives after considering information provided by those studies.

## **3. Investment Consultants**

The Board will hire a qualified independent consultant, whose relationship does not impose a conflict of interest with the Board or staff, to provide investment performance measurement at least quarterly with the report available to the Board within three months of the quarter end. The report will at least compare actual investment returns of the system -- in total, by each asset class, and for each managed portfolio -- with both the investment objectives of the system and a composite of returns of other institutional investors. The Board may hire other independent investment consultants as needed to assist the Board in the management of its investment activities, including, but not limited to: (1) performing asset allocation studies, and reviewing and recommending modifications of the asset allocation as conditions warrant; (2) assisting in monitoring the investment managers to assure they are in compliance with the investment policy and their individual guidelines; (3) performing manager evaluations and searches as may be necessary; and (4) assisting in the development and adjustment of investment policy. Except for consultants retained solely for purposes of performance measurement, consultants will be fiduciaries of the Trust.



## **D. Managers or Agents with Delegated Responsibilities**

### **1. Custodian**

#### **(a) Responsibilities**

The Board will hire custodians and other agents who will be fiduciaries of the Trust and who will assume full responsibility for the safekeeping and accounting of all assets held on behalf of the Trust. Among other duties as may be agreed to, the custodian will be responsible for: (a) the receipt, delivery, and safekeeping of securities; (b) the transfer, exchange, or redelivery of securities; (c) the claiming,

receipt, and deposit of all dividend, interest, and other corporate actions due the Trust; (d) the daily sweep of all uninvested funds into a cash management account or accounts; and, (e) the provision of reports to PERSI upon agreed time intervals that will include all purchases and sales of securities, all dividend declarations on securities held by the Trust, a list of securities held by the Trust, and a cash statement of all transactions for the Trust account.

#### **(b) Authorization of Collective Investment Trusts**

Assets of the Trust may be invested in any collective investment trust, which at the time of the investment provides for the pooling of the assets of plans described in Section 401(a) of the Internal Revenue Code of 1986, as amended, and which is exempt from Federal income tax. Assets of the Trust may be commingled with assets of other trusts if invested in any collective investment trust authorized by this policy. The provisions of the trust agreement, as amended by the trustee thereof from time to time, of each collective investment trust in which Trust assets are invested are by this reference incorporated as a part of the trust estate comprising the Trust. The provisions of the collective investment trust will govern any investment of Trust assets in that trust.

### **2. Investment Managers**

The Board will hire investment managers who will be fiduciaries of the Trust and who will be responsible for the investment of Trust assets in specific securities or assets within or among the asset classes.

#### **(a) Minimum Qualifications**

Investment managers shall be registered with the Securities and Exchange Commission (unless they are banks, insurance companies, or other category exempted from such registration requirements), have been in the business of investment management at least two years (or the main personnel of the investment management firm have worked together in the business of investment management for at least two years), and, usually, have other United States pension fund assets under management.

#### **(b) Guidelines**

Investment Managers shall manage assets in accordance with additional guidelines established by contract and as may be added to or modified from time to time. The additional guidelines will contain minimum diversification requirements that must be followed by that manager. These guidelines will also set out the investment return expected to be achieved by that manager, and shall be linked to a benchmark that represents the passive index fund that would be used to replicate the manager's assignment.

#### **(c) Responsibilities and Discretion**

Subject to the restrictions set out in this policy or as may be set out in individual contracts or guidelines, an investment manager shall have full discretionary power to direct the investment, exchange, and liquidation of the assets entrusted to that manager. The manager shall place orders to buy and sell securities and, by notice to the custodian, cause the custodian to deliver and receive securities on behalf of the Trust.

#### **(d) Corporate Governance**

The Board, unless otherwise stated, will delegate the voting of proxies to the investment manager or custodian. The Board will adopt and from time to time modify a proxy voting policy. The staff will review the investment manager's policies governing the voting of proxies to assure consistency both with the policy of the Board and, to the extent feasible, among the various investment managers.

**(e) Transactions and Brokerage**

All securities transactions shall be executed by reputable broker/dealers or banks, and shall be on a best price and best execution basis.

**3. Use of Passive and Active Managers**

**(a) Purpose and Use of Active Management**

The Board recognizes that passive (index fund) investing has lower costs than active investing, with regard to both management fees and transaction costs. Further, the Board also recognizes that there is uncertainty concerning whether active investing can generally outperform passive investing, particularly in the large, liquid, and efficient portions of the capital markets. Also, the Board has great confidence that a passive investment of assets in an efficient asset allocation will likely meet long-term (20 year) obligations.

Contribution rates, COLAs, and the ability to provide for gain-sharing, however, are based on 1-5 year returns. The Board does have concern that over 1-5 year periods the ability consistently to fund COLAs and to keep contribution rates stable are in considerable jeopardy from two sources: (1) expected "normal" market fluctuations are such that annual returns will likely not meet hurdle rates approximately 40% of the time, with actual negative returns to be expected once every six years; and (2) that most of Trust assets under the strategic asset allocation will be invested in U.S. capital markets, and are thus vulnerable to poor U.S. returns.

One purpose of active management of Trust assets is to address these two concerns. Active managers will be hired for the purpose of providing greater stability of returns, and better returns, than would be achievable under purely passive management over rolling 3-5 year periods. Active managers will be responsible for timing of markets and the tactical allocation of assets among and within the capital markets (including between the U.S. and international markets).

In addition to providing extra returns, active managers will also be employed to smooth returns, provide higher long-term returns, provide protection in adverse markets, and to add exposure and additional diversification to the portfolio than that achievable solely through investment in passive indices representing the strategic asset allocation and strategic policies.

**(b) Structure**

In using outside managers, the Board will favor a structure using a reasonable number of managers with broad mandates and benchmarks. This preference will be implemented so as to achieve the following goals: to relieve the Board from making timing decisions in allocating assets among numerous specialized managers, to simplify the structure of the fund, and to reduce the number of active managers and thus expenses to the Trust.

Passive managers will be favored for the core, liquid, efficient markets (such as S&P 500 stocks and U.S. Government/Corporate bonds), and active managers will be favored for relatively inefficient markets (such as international emerging markets). Global managers will be used to provide flexibility in reacting to near-term concerns that may arise concerning any particular region or market, particularly the U.S. capital markets, and to provide an appropriate balance between efficient long-term asset allocations (which favor US assets) and near-term allocations (which have a greater preference for international assets) to meet the real (inflation adjusted) return needs of the System. Consequently, actual allocations to international equities in the overall portfolio from time to time may be above that in the strategic asset allocation due to the activities of the global equity managers. The actual exposure to international equities will be maintained within the strategic range unless there is prior review by the Board before those ranges are exceeded.

**(c) Balance between Passive and Active Management**

The balance between active and passive management will be set from time to time with the following considerations in mind: concentration of active investment efforts where there is the most potential for excess returns, implementation of views concerning the state of the U.S. and international capital markets, and reduction of fees and other costs.

#### **(d) Monitoring Standards**

Active managers will be monitored under two standards: First, over rolling 3-5 year periods, managers will be expected to exceed, after fees, the benchmark index that represents the passive alternative to the mandate given the manager, and to rank in the top half of the universe of managers that best fits that manager's mandate. Second, over shorter periods of time, managers will be expected to maintain key personnel, a consistent style, and investment capability. Passive managers will be monitored on their ability to track their benchmark index over both short (1 quarter to one year) and long periods (3 to 5 year). The Board may consider other information it considers relevant, including composite manager indices, in determining whether to retain or terminate managers.

### **V. Asset Class Policies**

#### **A. U.S. Equities**

##### **1. Objective**

The overall objective of the U.S. equity asset class is to obtain, over time, a return after fees that equals or exceeds the returns of the Russell 3000 Index, both absolutely and on a risk-adjusted basis.

##### **2. Allowable Investments**

Managers may invest in stocks that do not pay dividends. Managers may invest in equity securities outside of the Russell 3000 Index. Managers may use derivative securities for purposes of enhancing liquidity, reducing transaction or other costs, or partially hedging an existing exposure in the portfolio.

##### **3. Manager Styles**

Managers for this asset class may include index funds, style managers (such as value and growth), "core" managers, and global managers. Global managers are managers who may invest in securities located anywhere in the world, both within and outside of the United States.

##### **4. Benchmarks**

The Russell 3000 index will be the benchmark for the passive index funds, core managers, and global managers. Other style or capitalization indices maintained by a qualified organization may be used as the benchmark for style managers. Active U.S. equity managers are expected to exceed, over rolling 3-5 year intervals, the applicable benchmark by 75 basis points annually after fees, and to rank in the top 50<sup>th</sup> percentile of active managers with similar mandates.

#### **B. International Equities**

##### **1. Objective**

The overall objective of the International Equity Asset Class is to obtain, over time, a return after fees that equals or exceeds the returns of the Morgan Stanley Capital International Europe, Australia, and Far East (MSCI EAFE) Index (unhedged), or the FT Actuaries World ex U.S. Index, both absolutely and on a risk-adjusted basis.

##### **2. Allowable Investments**

Managers may invest in stocks that do not pay dividends. Managers may invest in American Depositary Receipts or American Depositary Shares. Managers may invest in equity securities of companies or in countries that are not included in the indices. Managers may use derivative securities for purposes of enhancing liquidity, reducing transaction or other costs, or partially hedging an existing exposure in the portfolio. Managers may, at their discretion, hedge the currency exposure of all or part of their portfolios. Managers may not overhedge their portfolio, although proxy hedging for purposes of liquidity and cost savings is allowed.

##### **3. Manager Styles**

Managers for this asset class may include index funds, general international managers, regional or specialized managers (such as emerging markets), and global managers. The Board may from time to time hire a currency overlay manager to hedge the currency exposure in those portfolios where managers do not actively or normally consider hedging their exposure.

#### **4. Benchmarks**

The MSCI EAFE Index (unhedged), or the FT Actuaries World ex U.S. (unhedged) will be the benchmark for the passive index funds, general international managers, and global managers. Regional or specialized indices (unhedged) maintained by a qualified organization may be used as the benchmark for other active managers. Active international equity managers are expected to exceed, over rolling 3-5 year intervals, the applicable benchmark by 75 basis points annually after fees, and to rank in the top 50<sup>th</sup> percentile of active managers with similar mandates.

### **C. Fixed Income**

#### **1. Objectives**

The overall objective of the Fixed Income Asset Class is to obtain, over time, a return after fees that equals or exceeds the returns of the Lehman Brothers Aggregate Bond Index (Aggregate Bond Index) both absolutely and on a risk-adjusted basis.

The Fixed Income Asset Class shall consist of investments in mortgages and in both dollar and non-dollar fixed income securities. Mortgages shall consist of investments in mortgage backed securities, and direct ownership of commercial mortgages through the Idaho Commercial Mortgage Program.

The objective of the non-mortgage fixed income securities is to obtain, over time, a return after fees that equals or exceeds the returns of the Lehman Brothers Government/Credit Bond Index (Government/Credit Bond Index) on a risk-adjusted basis. The overall objective of the mortgage securities is to obtain, over time, a return after fees that equals or exceeds the returns of the Lehman Brothers Mortgage Index (Mortgage Index) on a risk-adjusted basis.

#### **2. Allowable Investments**

Managers may invest in debt securities that do not pay interest. Active managers may invest in securities in companies or countries not included in the indices. Managers may use derivative securities for purposes of enhancing liquidity, reducing transaction or other costs, or partially hedging an existing exposure in the portfolio. Fixed income managers may, at their discretion and to the extent allowed by their contracts and guidelines, use currency forward or futures markets as may be considered appropriate to implement fixed income strategies.

#### **3. Manager Styles**

Managers in this asset class may include index funds, domestic bond managers, specialized managers, and global managers.

#### **4. Benchmarks**

The Government/Corporate Index or Aggregate Index will be the benchmark for all non-mortgage fixed income managers. The Mortgage Index will be the benchmark for all mortgage managers. The Aggregate Index will be the benchmark for the asset class. Active fixed income managers are expected to exceed, over rolling 3-5 year intervals, the applicable benchmark by 25 basis points annually after fees, and to rank in the top 50<sup>th</sup> percentile of active managers with similar mandates.

### **D. Real Estate**

#### **1. Objectives**

Private equity real estate investments will be considered part of the U.S. Equity asset class. The overall objective of private equity real estate investments is to attain a 6% real rate of return overall, over a long-term holding period, as long as this objective is consistent with maintaining the safety of principal. The 6% real rate of return includes both income and appreciation, is net of investment management fees, and is net of inflation as is measured annually by the Consumer Price Index. Over a short term basis, the objective is to earn a nominal minimum income yield of 6% on each individual investment, or inflation plus 3%, whichever is greater.

#### **2. Allowable Investments**

Allowable private equity real estate investments will include open-end and closed-end commingled real estate funds, publicly traded real estate investment trusts, and direct real estate investments originated by selected real estate advisors who structure similar investments with other institutional investors. The

real estate asset sector will not include solely debt obligations; in particular, straight mortgage interests will be considered part of the fixed income asset class.

### **3. Need for Income Component of Return**

Upon acquisition, each real estate investment must have as a goal the expectation of production of annual income measured by realized return and not capital appreciation. Thus, a significant proportion of income producing properties and not purely development properties should be the objective of any commingled fund acquired.

### **4. Protection of the Trust**

Investment vehicles should be chosen that will protect the Trust, including provision for investments that do not contain debt or liability with recourse beyond the Trust commitment to the related business entity, provision for inspection and evaluation of environmental hazards prior to the purchase of any property, and the provision of insurance coverage to protect against environmental and natural hazards.

### **5. Reporting**

A comprehensive reporting system for individual investments or funds will be maintained so that poorly performing investments and deficiencies in portfolio diversification can be identified and active portfolio management facilitated. Investment managers shall be required to present opinions of fair market value as part of quarterly and annual reporting requirements, and audited financial statements shall be required at least annually for each investment entity.

## **E. Alternative Investments**

### **1. Definition and Board Approval**

The Board may from time to time authorize the investment of Trust assets in entities or structures that do not fit the asset descriptions listed above. Examples of such investments are venture capital partnerships, private equity, leveraged buy-out funds, private debt, and direct ownership of individual assets such as oil and gas partnerships. These investments shall only be entered into with the specific approval by the Board or a subcommittee given specific delegation by the Board of each investment vehicle, or investment manager.

### **2. Objectives and Benchmarks**

If the alternative investment is an equity investment, the objective for the investment will be to exceed, over time and after fees, the return achieved by the Russell 2000 Index times 1.35. If the alternative investment is a debt investment, then the objective will be to exceed, over time and after fees, the returns achieved by the Lehman Brothers Government/Credit Index plus 3%. It is recognized that these investments will experience greater volatility than the comparable publicly traded securities and indices.

## **VI. GASB 40 Reporting (Section VI adopted May 26, 2005)**

### **A. Purpose**

The Governmental Accounting Standards Board has identified that state and local governments have deposits and investments which are exposed to risks that may result in losses. GASB Statement number 40 (GASB 40) is intended to inform users of the financial statements about the risks that could affect the ability of a government entity to meet its obligations. GASB 40 has identified general deposit and investment risks as credit risk, including concentration of credit risk and custodial credit risk, interest rate risk, and foreign currency risk and requires disclosures of these risks and of policies related to these risks. This portion of the Investment Policy addresses the monitoring and reporting of those risks.

In general, the risks identified in GASB 40, while present, are diminished when the entire portfolio is viewed as whole. For example, interest rate risk experienced by fixed income instruments often react in the exact opposite direction as that experienced by equities. Thus, interest rate exposure as set out in GASB 40 will not reflect the cross-influences of impacts across the broad range of investments that make up the PERSI portfolio. And, in fact, the general underlying measures used in GASB 40 across most of the risks identified (credit, concentration, and interest rate risk in particular) were tools that were

developed primarily for portfolios dominated by fixed income investments, and are often only poorly transferred, if at all, to portfolios, like PERSI's, that are dominated by equity interests.

Consequently, it is the policy of PERSI that the risks addressed in GASB 40 are to be monitored and addressed primarily through the guidelines agreed to by those managers, and by regular disclosures in reports by managers of levels of risks that may exceed expected limits for those portfolios.

## **B. Specific Areas of Risk**

### **1. Credit Risk**

Summary: Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations to PERSI.

Policy: Managers will provide PERSI with expected credit risk exposures in their portfolio guidelines. If the actual credit risk exposure falls outside of these expectations, managers will be required to report these occurrences to Staff and these disclosures are to be made available to the Board.

### **2. Custodial Credit Risk**

Summary: Custodial credit risk is the risk that in the event of a financial institution or bank failure, the System would not be able to recover the value of their deposits and investments that are in the possession of an outside party.

Policy: PERSI minimizes exposure to custodial credit risk by requiring that investments, to the extent possible, be clearly marked as to PERSI ownership and further to the extent possible, be held in the System's name.

### **3. Concentration of Credit Risk**

Summary: Concentration of credit risk is the risk of loss that may be attributed to the magnitude of a government's investment in a single issue.

Policy: Managers will provide PERSI with expected concentration of credit risk exposures in their portfolio guidelines. If the concentration of credit risk exceeds expectations, managers are to be required to report these occurrences to Staff and these disclosures are to be made available to the Board. For the portfolio as a whole, staff will report to the Board at a regular Board meeting if the exposure to a non-US government guaranteed credit exceeds 5% of the total PERSI portfolio.

### **4. Interest Rate Risk**

Summary: Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Interest rate risk to PERSI's fixed income portfolio is monitored using the effective duration methodology. Effective duration measures the volatility of the price of a bond given a change in interest rates, taking into account the optionality on the underlying bond.

Policy: Managers will provide PERSI with the expected portfolio duration in their portfolio guidelines. If the duration of the portfolio differs from expectations, managers are to be required to report these occurrences to Staff and these disclosures are to be made available to the Board.

### **5. Foreign Currency Risk**

Summary: Foreign currency risk is the risk that changes in exchange rates will adversely impact the fair value of an investment. PERSI's currency risk exposures, or exchange rate risk, primarily reside within the international equity investment holdings.

Policy: The PERSI Board recognizes that international investments (equity or fixed income) will have a component of currency risk associated with it. Currency risk and hedging exposures are dependent on the underlying international exposure, which fluctuates over time. The individual manager guidelines will outline the expected currency exposures (either specifically or through ranges of security exposures to particular currency areas) of the underlying portfolio and if the actual currency exposure differs from the expected, managers are to be required to report these occurrences to staff and these disclosures are to be made available to the Board.

 **Investment Section** 

**VII. Asset Allocation**

For purposes of asset allocation, alternative equity investments will be treated as part of the U.S. equity asset class, and alternative debt investments will be treated as part of the fixed income asset class.

**STRATEGIC ASSET ALLOCATION**

<b>Asset Class</b>	<b>Expected Return</b>	<b>Expected Risk</b>	<b>Strategic Normal</b>	<b>Strategic Ranges</b>	<b>Actual Allocation Year Ended June 30, 2007</b>
U.S. Equity	9.65%	17%	55%	50% - 65%	60.4%
International Equity	9.65%	19%	15%	10% - 20%	15.3%
Total Equities			70%	66% - 77%	75.7%
Fixed Income	5.8%	5%	30%	23% - 33%	24.2%
Cash	4.0%	1%	0%	0% - 5%	0.1%

<b>Total Fund</b>	<b>Expected Return</b>	<b>Expected Inflation</b>	<b>Expected Real Return</b>	<b>Expected Risk</b>
Actuary	7.75%	3.75%	4.00%	n/a
Portfolio	8.50%	3.50%	5.00%	11.70%