

FINANCIAL SECTION



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Independent Auditor's Report

The Board of Trustees
Public School Employees' Retirement System
Harrisburg, Pennsylvania

We have audited the accompanying financial statements of the Public School Employees' Retirement System (PSERS), a component unit of the Commonwealth of Pennsylvania, as of and for the years ended June 30, 2012 and 2011, as listed in the table of contents. These financial statements are the responsibility of PSERS' management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, PSERS' plan net assets as of June 30, 2012 and 2011, and the changes in its plan net assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Accounting principles generally accepted in the United States of America require that the Management's Discussion and Analysis and Required Supplementary Schedules of Funding Progress and Employer Contributions (Required Supplementary Schedules 1 and 2) be presented to supplement the financial statements. Such information, although not a part of the financial statements, is required by the Governmental Accounting Standards Board, who considers it to be an essential part of financial reporting for placing the financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the financial statements, and other knowledge we obtained during our audit of the basic financial statements. However, we did not audit the information and express no opinion on it.

Our audits were made for the purpose of forming an opinion on the financial statements taken as a whole. Supplementary Schedules 1 through 3, are presented for purposes of additional analysis and are not a required part of the financial statements. Supplementary Schedules 1 through 3 are the responsibility of management and have been subjected to the auditing procedures applied in the audit of the basic financial statements. In our opinion, the information is fairly stated, in all material respects, in relation to the financial statements taken as a whole.

The Introductory, Investment, Actuarial and Statistical Sections have not been subject to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

CliftonLarsonAllen LLP

Baltimore, Maryland
September 18, 2012

Management's Discussion and Analysis

Management's Discussion and Analysis (MD&A) of the Commonwealth of Pennsylvania Public School Employees' Retirement System (PSERS, System, Fund) for the fiscal year ended June 30, 2012 (FY 2012) provides a narrative summary of PSERS' financial position and performance, including highlights and comparative data. The MD&A is presented as required supplementary information to the financial statements and should be read in conjunction with the financial statements, the notes to financial statements, and the supplementary schedules.

Overview of Financial Statements

PSERS is primarily responsible for administering a defined benefit pension plan for public school employees in the Commonwealth of Pennsylvania. PSERS also administers two postemployment healthcare programs, the Health Insurance Premium Assistance Program (PA) and the Health Options Program (HOP), for its annuitants. The financial statements present the financial position and activities for the pension plan and the two postemployment healthcare programs.

The *Statements of Plan Net Assets* provide a snapshot of the financial position of PSERS at June 30, 2012, including comparative amounts for the prior year.

The *Statements of Changes in Plan Net Assets* summarize PSERS' financial activities that occurred during the fiscal period from July 1, 2011 to June 30, 2012, including comparative amounts for the prior year.

The *Notes to Financial Statements* provide additional information that is essential to a full understanding of the financial statements. The notes are an integral part of the financial statements and include detailed information not readily evident in the basic financial statements such as accounting policies, plan membership and benefits, and summary disclosures of selected financial data.

The *Required Supplementary Schedules* immediately following the notes to financial statements provide two schedules illustrating historical information concerning the funded status of PSERS and the employer contributions. These schedules emphasize the long-term nature of the pension and premium assistance plans and show the progress of PSERS in accumulating assets sufficient to pay benefits when due.

The remaining supplementary schedules provide additional detailed information concerning the operating expenses, investment expenses and payments to non-investment consultants. All of this supplementary information is considered useful in understanding and evaluating the financial activities of PSERS.

Financial Highlights

- The rate of return on investments was 3.43% for fiscal year ended June 30, 2012, 20.37% for the fiscal year ended June 30, 2011 (FY 2011) and 14.59% for the fiscal year ended June 30, 2010 (FY 2010). The annualized rate of return for the three years ended June 30, 2012 was 12.57%, which exceeded the 7.5% actuarial investment rate of return assumption. Unless otherwise noted, all rates of return are net of fees.
- PSERS' total plan net assets decreased by \$2.6 billion from \$51.4 billion at June 30, 2011 to \$48.8 billion at June 30, 2012. This decrease was due in large part to deductions for benefits and administrative expenses exceeding net investment income plus member and employer contributions. The change in total plan net assets from June 30, 2010 to June 30, 2011 was an increase of \$5.6 billion from \$45.8 billion at June 30, 2010 to \$51.4 billion at June 30, 2011. This increase was due in large part to net investment income plus member and employer contributions exceeding the deductions for benefits and administrative expenses.
- PSERS' funded ratio for the pension plan, as of the latest actuarial valuation dated June 30, 2011, decreased from 75.1% at June 30, 2010 to 69.1% at June 30, 2011. This decrease was primarily due to experience losses on investment assets, assumption changes, and employer contributions that were less than the normal cost plus interest on the unfunded liability. The funded ratio at June 30, 2009 was 79.2%.
- Total member contributions decreased from \$1.24 billion in FY 2011 to \$1.17 billion in FY 2012. The decrease was due to a 2.6% decrease in the active member payroll and fewer purchase of service contributions. The portion of member contributions for the HOP grew due to increased participation as well as ongoing health insurance rate increases.
- Total employer contributions increased from \$747.8 million during FY 2011 to \$1.1 billion in FY 2012. This increase was primarily attributable to an increase in the total employer contribution rate from 5.64% in FY 2011 to 8.65% in FY 2012 which was partially offset by a 2.6% reduction in active member payroll. Total employer contributions increased from FY 2010 to FY 2011 which was attributable to an increase in the total employer contribution rate from 4.78% in FY 2010 to 5.64% in FY 2011 and an increase in the active member payroll.

FINANCIAL SECTION

Management's Discussion and Analysis (continued)

- Total PSERS' benefit expense increased by \$400 million from \$5.6 billion in FY 2011 to \$6.0 billion in FY 2012. This increase is attributable to the number of new retirements for the year, higher lump sum payments as well as an ongoing increase to the average monthly benefit and the number of members receiving benefits. New retirements during FY 2012 outpaced those of FY 2011 by approximately 6%. Total PSERS' benefit expense increased by \$300 million from \$5.3 billion in FY 2010 to \$5.6 billion in FY 2011. This increase is attributable to the number of new retirements for the year, higher lump sum payments as well as an ongoing increase to the average monthly benefit, and the number of members receiving benefits.
- Total PSERS' administrative expenses decreased slightly from \$57.7 million for FY 2011 to \$56.5 million in FY 2012 as PSERS continued to diligently control administrative expenses. Total PSERS' administrative expenses increased from \$30.5 million in FY 2010 to \$57.7 million for FY 2011. This overall increase is primarily due to the impact of the capitalization of intangible assets as a result of PSERS' implementation of Governmental Accounting Standards Board (GASB) Statement No. 51 *Accounting and Financial Reporting for Intangible Assets* in FY 2010. This adjustment resulted in a \$23.8 million reduction in FY 2010.

Analysis of Plan Net Assets					
(Dollar Amounts in Thousands)					
Summary of Plan Net Assets	FY 2012	Increase (Decrease)	FY 2011	Increase (Decrease)	FY 2010
Assets:					
Receivables	\$ 1,433,111	\$ 258,554	\$ 1,174,557	\$ 109,496	\$ 1,065,061
Investments	48,540,849	(3,288,315)	51,829,164	5,324,896	46,504,268
Securities lending collateral pool	506,804	(255,001)	761,805	(762,429)	1,524,234
Capital assets	22,333	1,304	21,029	1,814	19,215
Total Assets	50,503,097	(3,283,458)	53,786,555	4,673,777	49,112,778
Liabilities:					
Payables and other liabilities	1,232,714	(358,855)	1,591,569	(159,448)	1,751,017
Obligations under securities lending	506,804	(255,001)	761,805	(762,429)	1,524,234
Total Liabilities	1,739,518	(613,856)	2,353,374	(921,877)	3,275,251
Plan Net Assets	\$48,763,579	\$(2,669,602)	\$ 51,433,181	\$5,595,654	\$ 45,837,527
Summary of Changes in Plan Net Assets					
Additions:					
Contributions	\$ 2,285,918	\$ 262,364	\$ 2,023,554	\$ 208,388	\$ 1,815,166
Net investment income	1,093,979	(8,153,113)	9,247,092	3,132,104	6,114,988
Total Additions	3,379,897	(7,890,749)	11,270,646	3,340,492	7,930,154
Deductions:					
Benefit expense	5,992,979	375,732	5,617,247	348,072	5,269,175
Administrative expenses	56,520	(1,225)	57,745	27,253	30,492
Total Deductions	6,049,499	374,507	5,674,992	375,325	5,299,667
Changes in Plan Net Assets	\$(2,669,602)	\$(8,265,256)	\$ 5,595,654	\$2,965,167	\$ 2,630,487

Management’s Discussion and Analysis (continued)

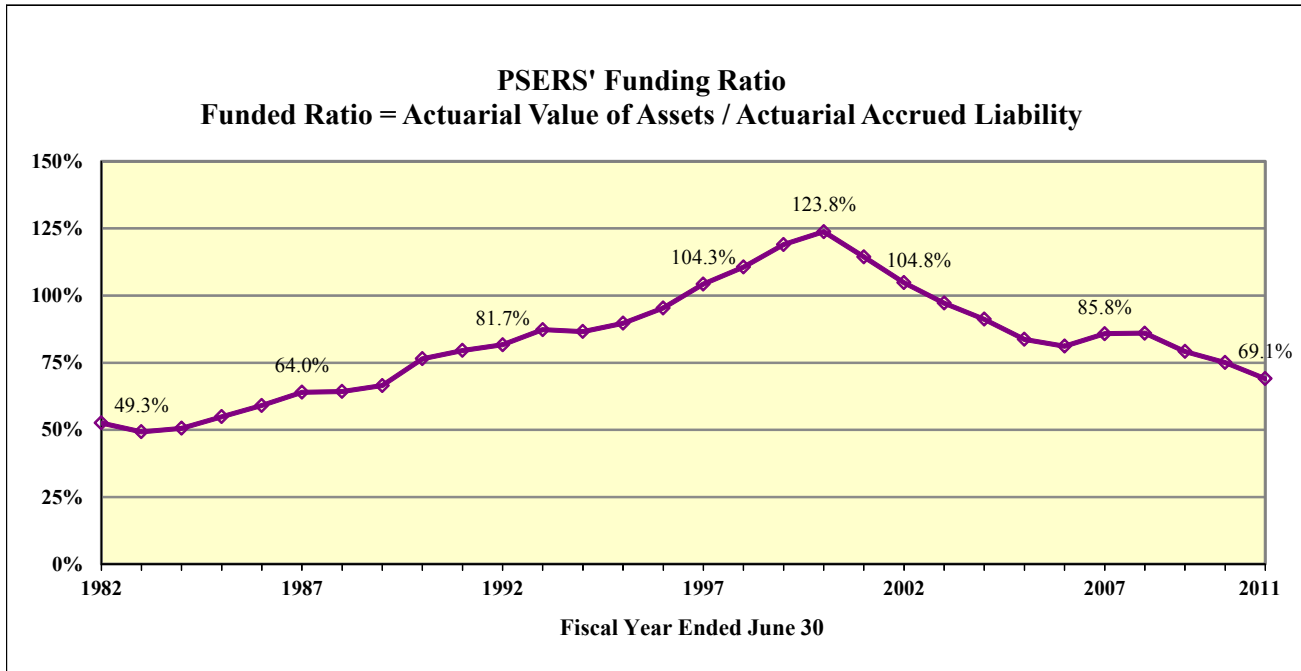
Funded Status

PSERS uses an actuarial reserve type of funding that is financed by member contributions, employer contributions, and earnings from invested assets. An independent actuarial valuation of PSERS’ actuarial assets and liabilities is performed annually. As part of this valuation, the progress toward funding pension obligations of PSERS is measured by comparing the actuarial value of assets to the actuarial accrued liability. This measurement is referred to as the funded ratio or funded status. The most recent actuarial valuation reports that PSERS’ pension is 69.1% funded as of June 30, 2011. The funded ratio decreased from 75.1% as of June 30, 2010 due to a decrease in the actuarial value of assets, which is based on a ten-year smoothing period, employer contributions below the normal cost plus interest, and an increase in the actuarial accrued liability which was partially due to a change in actuarial assumptions.

The results of operations for FY 2012 will be reflected in the actuarial valuation for the year ended June 30, 2012. Due to the normal lag time for completion of the actuarial

valuation, the resulting funded status will be available at the end of the 2012 calendar year and will be reported in the financial statements for the fiscal year ending June 30, 2013 (FY 2013). Based on the investment performance for the eight-year period ended June 30, 2012, which is below the investment rate of return assumption during that time period, and employer contributions below the normal cost plus interest, the funded ratio at June 30, 2012 is expected to decrease. FY 2012 is the third year of a five year transition from five-year to ten-year smoothing of actuarial assets. A thirty year history of PSERS’ funded status is shown at the bottom of the page.

PSERS’ State Accumulation Account had a negative balance at June 30, 2012 and 2011 (See Note 3). The deficit increased in FY 2012 due to a change in actuarial assumptions in the June 30, 2011 valuation, which was reflected in FY 2012, employer contributions below the normal cost plus interest and investment returns below the rate of return assumption. Employer contributions and investment earnings will be used to reduce the deficit in this Account in the future.



FINANCIAL SECTION

Management's Discussion and Analysis (continued)

Investments

PSERS is a long-term investor and manages the pension fund with long-term objectives in mind. A primary element of PSERS' investment philosophy is diversification among various asset classes, which is the best way to achieve its goals. PSERS makes estimates of future long-term market returns and establishes an asset allocation plan taking into account the risk associated with each asset class as well as the financial objectives of the Fund.

Domestically, the equity markets incurred steep losses during the third quarter of 2011 as the result of a bitter and partisan U.S. debt ceiling debate, which ultimately ended with an increase in the debt ceiling and led Standard & Poor's to downgrade the credit rating of United States government debt from AAA to AA+. The U.S. Gross Domestic Product (GDP) was fairly tepid during the past fiscal year with the exception of a slight pickup in the fourth quarter of 2011. The announcement on September 21, 2011 of the Federal Reserve's "Operation Twist" strategy (a plan to sell short-term notes and purchase long-term Treasuries to reduce interest rates) was a catalyst for the fourth quarter 2011 rally. One potential positive for the U.S. economy as of June 2012 and going forward is the apparent stabilization of the U.S. housing market as measured by the S&P Case-Shiller 20-City Home Price Index, which is up slightly since last June and is up 3.56% since its January 2012 lows. Internationally, the markets have been driven by both the continuing European debt crisis as well as a significant deceleration of growth in China. The debt problems continue to plague the peripheral European countries and demands for austerity measures in the Eurozone dampen growth forecasts and hurt equity markets in Europe. In China, real GDP has decelerated from 9.5% in the second quarter of 2011 to 7.6% in the second quarter of 2012. As a large and growing engine

for world growth, the economic slow-down in China has caused global concerns. Despite these hurdles, PSERS outperformed more than 85 percent of the public pension plans in the Wilshire Compass All Public Funds Universe.

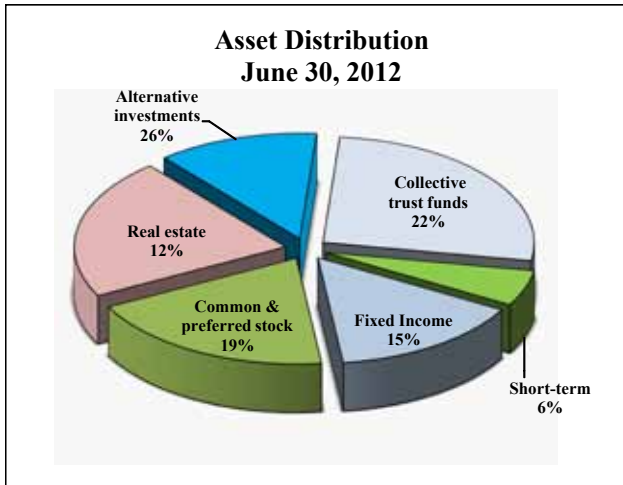
For FY 2012 PSERS' rate of return on investments was 3.43% which exceeded PSERS' total fund Policy Index of 1.98%. The Policy Index is a custom benchmark, which is based on the Board-established asset allocation structure, that seeks to generate a return that meets the actuarial rate of return assumption. Net investment income of \$1.1 billion in FY 2012 decreased from a net investment income of \$9.2 billion in FY 2011.

The annualized rate of return over the past three and five-year periods ended June 30, 2012 was 12.57% and .37%, respectively. The return for the three-year period exceeded the total fund Policy Index return by 263 basis points while the return for the five-year period trailed the total fund Policy Index return by 22 basis points. The annualized rate of return for the ten and twenty-five-year periods ended June 30, 2012 was 7.19% and 8.42%, respectively.

PSERS' long-term actuarial investment rate of return assumption was 7.5% at June 30, 2012. PSERS' Board of Trustees (Board) decreased the actuarial investment rate of return assumption from 8.0% to 7.5% for the June 30, 2011 actuarial valuation. The change made by the Board lowered PSERS' rate of return assumption to provide a more realistic outlook on the future earnings potential of the Fund as long-term capital market assumptions have declined.

The asset distribution of PSERS' investment portfolio at June 30, 2012, 2011 and 2010, at fair value, and including postemployment healthcare assets, is presented in the table at the bottom of the page.

<u>Asset Class</u>	(Dollar Amounts in Thousands)					
	<u>2012</u>	<u>%</u>	<u>2011</u>	<u>%</u>	<u>2010</u>	<u>%</u>
Short-term	\$ 2,649,495	5.5	\$ 5,813,421	11.2	\$ 4,163,515	9.0
Fixed income	7,207,558	14.8	8,527,633	16.4	8,645,356	18.6
Common and preferred stock	9,357,122	19.3	11,319,183	21.8	10,908,365	23.5
Collective trust funds	10,460,482	21.5	8,320,294	16.1	7,636,438	16.4
Real estate	6,003,753	12.4	5,263,467	10.2	3,973,873	8.5
Alternative investments	12,862,439	26.5	12,585,166	24.3	11,176,721	24.0
Total	\$ 48,540,849	100.0	\$ 51,829,164	100.0	\$ 46,504,268	100.0

Management's Discussion and Analysis (continued)

Short-term investments (cash and cash equivalents) decreased by \$3.2 billion from \$5.8 billion at June 30, 2011 to \$2.6 billion at June 30, 2012. This asset class was overweighted at June 30, 2011 and underweighted at June 30, 2012 according to the asset allocation plans approved by the Board. Due to manager terminations, reallocation of investments and funding for benefit payments, PSERS decreased its short-term investments during FY 2012. Fixed income investments decreased by \$1.3 billion from \$8.5 billion at June 30, 2011 to \$7.2 billion at June 30, 2012 mostly due to manager terminations and reallocation of exposure to other asset classes during FY 2012. Common and preferred stock investments also decreased by \$1.6 billion from \$11.0 billion at June 30, 2011 to \$9.4 billion at June 30, 2012. The reduction in this asset category was mainly the result of negative returns in the international equity market. Collective trust funds rose by \$1.9 billion from \$8.6 billion at June 30, 2011 to \$10.5 billion at June 30, 2012 mostly due to a reallocation of exposure from other asset classes. Real estate investments increased by \$700 million from \$5.3 billion at June 30, 2011 to \$6.0 billion at June 30, 2012 due to contributions to new and existing partnerships combined with a recovery of value in partnership portfolio holdings.

Short-term investments (cash and cash equivalents) increased by \$1.6 billion from \$4.2 billion at June 30, 2010 to \$5.8 billion at June 30, 2011 due to a reallocation of exposure from common and preferred stocks during FY 2011. Collective trust funds increased by \$1 billion from \$7.6 billion at June 30, 2010 to \$8.6 billion at June 30, 2011 due to market value appreciation and allocation increases to the asset class. Real estate investments rose by \$1.3 billion from \$4.0 billion at June 30, 2010 to \$5.3 billion at June 30, 2011 mostly as a result of contributions to new and existing partnerships combined with market recovery. Alternative investments increased by \$1.4 billion from \$11.2 billion at June 30, 2010 to \$12.6 billion at June 30, 2011 due to contributions to new and existing partnerships

combined with strong appreciation in partnership portfolio investments, which outweighed significant distributions.

Securities Lending

The System experienced only a slight change in net income from securities lending activities from \$7.2 million in FY 2011 to \$8.3 million in FY 2012 as spreads improved and volume increased.

Contributions

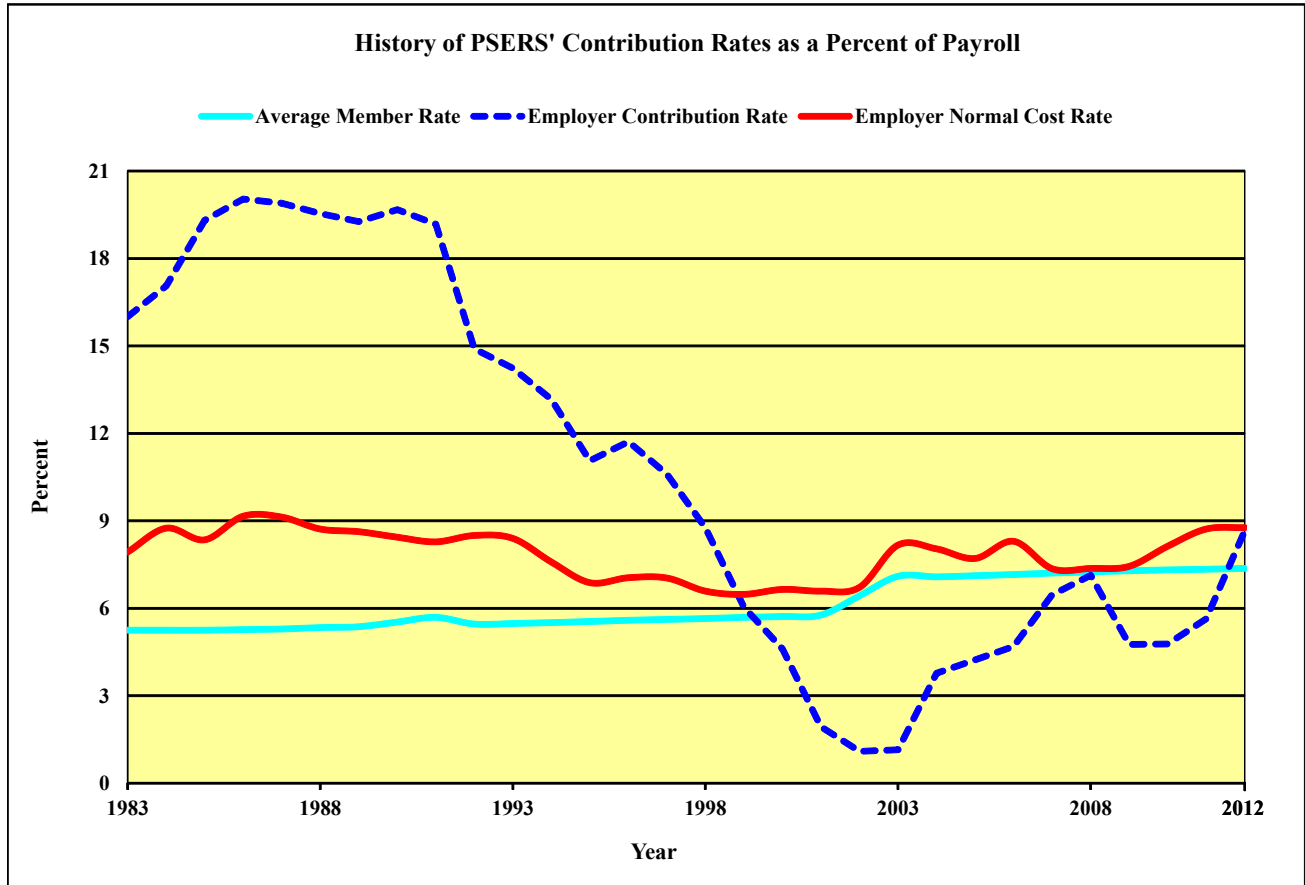
Employer contributions increased from \$747.8 million in FY 2011 to \$1.1 billion in FY 2012 due to the increase in the total employer contribution rate from 5.64% in FY 2011 to 8.65% in FY 2012. The decrease in active member payroll partially offset the increase in contribution rate. Active member payroll decreased 2.6% from FY 2011 to FY 2012. This was the first active member payroll decrease in over 20 years.

Total member contributions decreased from \$1.24 billion in FY 2011 to \$1.17 billion in FY 2012 due to a decrease in active member payroll for pension offset by a slight increase in the average member contribution rate and increased participation in the HOP. The average member contribution rate for pension increased from 7.34% in FY 2011 to 7.37% in FY 2012. Total member contributions increased from \$1.14 billion in FY 2010 to \$1.24 billion in FY 2011 as a result of the increase in the average member contribution rate and total active member payroll for pension and increased participation in the HOP. The average member contribution rate for pension increased from 7.32% in FY 2010 to 7.34% in FY 2011.

A thirty-year history of PSERS' contribution rates is presented on the next page.

As a result of a decrease in active member payrolls and a decrease in service credit purchases by members from FY 2011 to FY 2012, member contribution receivables decreased from \$306.4 million at June 30, 2011 to \$290.1 million at June 30, 2012. The increase in the employer contribution rate from FY 2011 to FY 2012 offset the effects of the decrease in the active member payrolls and lower employer cost of service credit purchases and resulted in the employer contribution receivable rising from \$224.6 million at June 30, 2011 to \$319.2 million at June 30, 2012.

Management’s Discussion and Analysis (continued)



Pennsylvania Act 120 of 2010

On November 23, 2010, the Governor signed HB 2497 into law. The legislation is now known as Act 120 of 2010.

Act 120 preserves the benefits of existing members and includes a series of actuarial and funding changes to PSERS and benefit reductions for individuals who become new members of PSERS on or after July 1, 2011. The Act created two new membership classes, T-E and T-F.

Act 120 has a projected net savings of \$1.38 billion thru FY 2044 as the \$24.65 billion of projected savings from benefit reductions is offset by the \$23.27 billion cost of deferring contributions for budgetary purposes. Act 120 addressed the pending employer contribution rates spike projected for FY 2013 by smoothing the projected rate increases over a five to nine year time period. In addition, the benefit reductions and risk sharing provisions for new members on July 1, 2011 and thereafter have created a low employer cost structure for new members and shifted some of the investment risk to members. The employer normal cost for Act 120 members is 68% less than pre-Act 120 members as the benefit plan is primarily member funded.

Benefit Changes

All new members will automatically become Class T-E members. New members however, will have a one-time opportunity to elect Class T-F within 45 days of receiving written notification from PSERS. Failure to elect Class T-F at time of original eligibility will make the member ineligible for Class T-F forever. In other words, once the election is made either by action or inaction, the election is permanent. Provisions affecting both new membership classes are as follows:

- The cost to purchase Non Qualifying Part Time (NQPT) service and most types of nonschool or nonstate service credit (other than military service) will be the full actuarial cost of the service.
- Ten year vesting period.
- For normal retirement, employees must work until age 65 with a minimum of 3 years of service, or attain a total combination of age and service that is equal to or greater than 92 with a minimum of 35 years of service.
- No projection of service for determining normal retirement.

Management's Discussion and Analysis (continued)

- Cannot withdraw contributions and interest in a lump sum when retiring.
- Pension benefit cannot exceed the member's final average salary.
- New employees starting later than July 1, 2011 will contribute based on the "shared risk" rate in effect at date of hire.

Benefit and contribution rates for the new membership classes are as follows:

Class T-E

- Final average salary multiplier is 2% as opposed to 2.5% multiplier for most current members.
- Employee contribution base rate is 7.5% (base rate) with a "shared risk" provision that could cause the total contribution levels to fluctuate between 7.5% and 9.5%.

Class T-F

- Final average salary multiplier is 2.5%.
- Employee contribution base rate is 10.3% (base rate) with a "shared risk" provision that could cause the total contribution levels to fluctuate between 10.3% and 12.3%.

With a "shared risk" program, Class T-E and T-F members benefit when investments of the fund are doing well and share some of the risk when investments underperform. The member contribution rate will stay within the specified range allotted for Class T-E or T-F; but could increase or decrease by .5% every three years starting July 1, 2015, dependent on investment performance of PSERS. The member contribution rate could never go below the base rate of 7.5% for T-E and 10.3% for T-F members, or above 9.5% for T-E and 12.3% for T-F members.

Funding/Actuarial Changes Summary

Funding Changes - Employer Contributions

The legislation also suppresses the employer contribution rate by using rate caps in future years to

keep the rate from rising too high, too fast for budgetary purposes.

The rate caps limit the amount the pension component of the employer contribution rate can increase over the prior year's rate as follows:

- FY 2012 - not more than 3.0% plus the premium assistance contribution rate
- FY 2013 - not more than 3.5% plus the premium assistance contribution rate
- FY 2014 and thereafter - not more than 4.5% plus the premium assistance contribution rate

The rate cap remains at 4.5% until the rate cap no longer applies, i.e. the rise in the employer contribution rate is less than the rate cap in effect at that time. Once the rate caps no longer apply, the employer normal cost becomes the contribution rate floor.

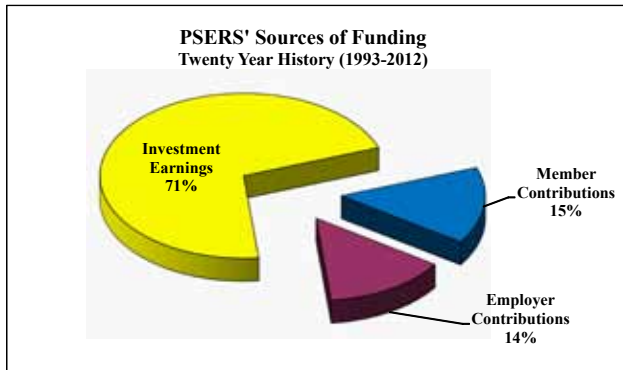
Actuarial Changes

- Currently liabilities are funded over various periods of time using level dollar amortization. Act 120 re-amortizes all unfunded liabilities over a 24 year period and uses level percentage of pay amortization.
- Level percentage of pay amortization is calculated using the same percentage of compensation each year during the amortization period. Under the level dollar amortization, the annual dollar amount of the payment remains the same each year.
- Act 120 changes the recognition of investment gains and losses from a five year smoothing period to a ten year smoothing period.
- Any future legislation enacted that adds liabilities to the system (i.e. cost-of-living adjustments, "30 and Out") will be amortized over ten years, using a level percentage of pay method. The cost of any additional accrued liability must be reflected above the employer contribution rate caps.
- The use of Pension Obligation Bonds to fund the System is prohibited.

Management’s Discussion and Analysis (continued)

Investment Income

Net investment income decreased from \$9.2 billion in FY 2011 to \$1.1 billion in FY 2012, which is consistent with the decrease in the investment rate of return from 20.37% for FY 2011 to 3.43% for FY 2012. Net investment income changed by \$3.1 billion from \$6.1 billion in FY 2010 to \$9.2 billion in FY 2011, which is consistent with the increase in the investment rate of return from 14.59% for FY 2010 to 20.37% for FY 2011. As depicted in the following chart, investment earnings provided 71% of PSERS’ funding over the past 20 years. Net investment income also includes investment expenses as a deduction. The “Total PSERS’ Benefits and Expenses” section that follows includes an analysis of investment expenses.



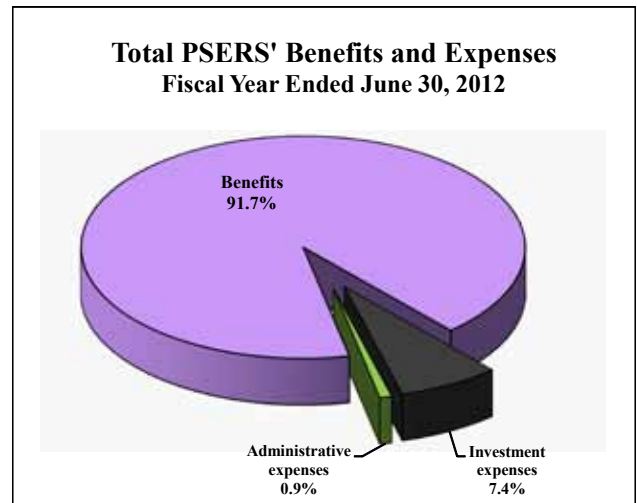
Total PSERS’ Benefits and Expenses

The primary source of expense during FY 2012 was for the payment of benefits approximating \$6.0 billion. The breakdown consisted of \$5.7 billion for Pension, \$97.0 million for the PA program, and \$213.0 million for HOP benefits. The chart at the end of this page illustrates the significant portion of expenses attributable to benefit payments.

Total PSERS’ benefit expense increased from \$5.6 billion in FY 2011 to \$6.0 billion in FY 2012. The increase is attributable to higher lump sum payments as well as an ongoing increase to the average monthly benefit and an increase in the number of members receiving benefits. There was a decrease in fourth quarter retirements, in FY 2012 versus the same period in FY 2011, resulting in a lower pension benefits payable figure at June 30, 2012 of \$495.0 million compared to \$646.4 million at June 30, 2011. New retirements during FY 2012 outpaced the number from FY 2011 by approximately 6%. Benefit expense increased from \$5.3 billion in FY 2010 to \$5.6 billion in FY 2011. This increase is attributable to the number of new retirements for the year, higher lump sum payments, as well as an ongoing increase to the average monthly benefit.

Investment expenses decreased by \$33.4 million from \$514.7 million in FY 2011 to \$481.3 million in FY 2012 mainly due to a decline in management fees in the real estate and alternative investment asset classes. This reduction is widely attributable to changes in fee structure brought on by partnerships maturing. Also contributing to this change was a decrease in performance fees in the public market sector from FY 2011 to FY 2012. Investment expenses decreased by \$7.6 million from \$522.3 million in FY 2010 to \$514.7 million in FY 2011 mainly due to a decline in management fees in the alternative investment asset class. This reduction is widely attributable to changes in fee structure brought on by partnerships maturing.

Administrative expenses decreased by \$1.2 million from \$57.7 million during FY 2011 compared to \$56.5 million during FY 2012 as PSERS continued to diligently control administrative expenses. FY 2012 and FY 2011 are more consistent with historical values. FY 2010 administrative expenses of \$30.5 million were significantly lower due to a \$23.8 million reduction from the capitalization of previously expensed GASB 51 qualifying costs for computer systems development.



Management's Discussion and Analysis (continued)**Postemployment Healthcare**

PSERS administers two postemployment healthcare programs, the Health Insurance Premium Assistance Program (PA) and the Health Options Program (HOP) for its annuitants. The following paragraphs and summary financial data provide supplementary information to the financial statements which contain the financial position and activities for the two postemployment healthcare programs.

Financial Highlights for Postemployment Healthcare**Health Insurance Premium Assistance (PA) Program**

- Total plan net assets decreased by \$17.5 million in FY 2012 due to a decrease in employer contributions and an increase in benefit payments. The change from June 30, 2010 to June 30, 2011 was a decrease of \$5.6 million due to benefit payments and the associated administrative expenses exceeding employer contributions.
- Total receivables decreased slightly from \$32.6 million at June 30, 2011 to \$29.1 million at June 30, 2012 due to lower active member payroll. This was slightly offset by an increase in the contribution rate from .64% to .65% for FY 2011 and FY 2012, respectively.
- Investments decreased from \$80.6 million at June 30, 2011 to \$65.1 million at June 30, 2012 due to net cash outflows caused by expenditures exceeding contributions and income.

Health Options Program (HOP)

- Total plan net assets increased by \$14.1 million in FY 2012 primarily due to the rise in contributions that outpaced expenses. The change from June 30, 2010 to June 30, 2011 is primarily due to the rise in claims expenditures outpacing the rise in contributions by almost a 3 to 1 margin.
- Total receivables increased from \$13.8 million at June 30, 2011 to \$16.8 million at June 30, 2012. The increase is tied primarily to higher contributions due to an increase in participation in the HOP.
- Investments increased from \$145.9 million at June 30, 2011 to \$157.8 million at June 30, 2012 due to

increased participation, which increased contributions and improved cash flow.

- Total liabilities increased 2.2% from June 30, 2011 to June 30, 2012. The increase is due to increased participation in the program slightly offset by a decrease in claims payable.

Contributions

- Total employer contributions for PA decreased from \$89.2 million in FY 2011 to \$81.3 million in FY 2012 due to the decrease in employer reported salaries from FY 2011 to FY 2012. The contribution rate had a small increase, going from 0.64% in FY 2011 to 0.65% in FY 2012, which did not have a significant impact on the total contributions due to lower reported active member payroll.
- Total member and Centers for Medicare and Medicaid Services (CMS) contributions for HOP increased from \$233.1 million in FY 2011 to \$247.1 million in FY 2012. This increase is representative of the 7.8% increase in plan participation.

Investment Income

- Total investment income for PA decreased from \$0.7 million in FY 2011 to \$0.4 million in FY 2012. The decrease is due to declining short-term interest rates from FY 2011 to FY 2012 and a reduction in investments.
- Investment income for HOP decreased from \$0.3 million in FY 2011 to \$0.2 million in FY 2012. This decrease is due to lower rates of return on short-term investments.

Benefits and Expenses

- Overall expenses for PA increased from \$95.5 million in FY 2011 to \$99.3 million in FY 2012. This increase is primarily due to the increase in number of members receiving premium assistance benefits.
- Overall expenses for HOP were relatively unchanged totaling \$233.7 million in FY 2011 and \$233.2 million in FY 2012.

FINANCIAL SECTION

Management's Discussion and Analysis (continued)

Premium Assistance

Summary of Plan Net Assets

(Dollar Amounts in Thousands)

Assets:	FY 2012	Increase (Decrease)	FY 2011	Increase (Decrease)	FY 2010
Receivables	\$ 29,102	\$ (3,519)	\$ 32,621	\$ (4,919)	\$ 37,540
Investments	65,072	(15,515)	80,587	739	79,848
Total Assets	94,174	(19,034)	113,208	(4,180)	117,388
Liabilities					
Payables and other liabilities	421	(1,529)	1,950	1,393	557
Total Liabilities	421	(1,529)	1,950	1,393	557
Plan Net Assets	\$ 93,753	\$ (17,505)	\$ 111,258	\$ (5,573)	\$ 116,831

Summary of Changes in Plan Net Assets

Additions:	FY 2012	Increase (Decrease)	FY 2011	Increase (Decrease)	FY 2010
Contributions	\$ 81,343	\$ (7,899)	\$ 89,242	\$ (13,461)	\$ 102,703
Net Investment Income	423	(268)	691	(178)	869
Total Additions	81,766	(8,167)	89,933	(13,639)	103,572
Deductions:					
Benefit Expenses	97,206	3,688	93,518	3,607	89,911
Administrative Expenses	2,065	77	1,988	44	1,944
Total Deductions	99,271	3,765	95,506	3,651	91,855
Changes in Plan Net Assets	\$ (17,505)	\$ (11,932)	\$ (5,573)	\$ (17,290)	\$ 11,717

Health Options Program

Summary of Plan Net Assets

(Dollar Amounts in Thousands)

Assets:	FY 2012	Increase (Decrease)	FY 2011	Increase (Decrease)	FY 2010
Receivables	\$ 16,813	\$ 3,044	\$ 13,769	\$ 351	\$ 13,418
Investments	157,785	11,884	145,901	3,465	142,436
Total Assets	174,598	14,928	159,670	3,816	155,854
Liabilities					
Payables and other liabilities	38,568	827	37,741	4,108	33,633
Total Liabilities	38,568	827	37,741	4,108	33,633
Plan Net Assets	\$ 136,030	\$ 14,101	\$ 121,929	\$ (292)	\$ 122,221

Summary of Changes in Plan Net Assets

Additions:	FY 2012	Increase (Decrease)	FY 2011	Increase (Decrease)	FY 2010
Contributions	\$ 247,104	\$ 14,010	\$ 233,094	\$ 8,009	\$ 225,085
Net Investment Income	237	(73)	310	(130)	440
Total Additions	247,341	13,937	233,404	7,879	225,525
Deductions:					
Benefit Expenses	213,027	(1,940)	214,967	21,660	193,307
Administrative Expenses	20,213	1,484	18,729	2,286	16,443
Total Deductions	233,240	(456)	233,696	23,946	209,750
Changes in Plan Net Assets	\$ 14,101	\$ 14,393	\$ (292)	\$ (16,067)	\$ 15,775

FINANCIAL SECTION

Statements of Plan Net Assets June 30, 2012 and 2011 (Dollar Amounts in Thousands)

	2012			
	Pension	Postemployment Healthcare		Totals
		Premium Assistance	Health Options Program	
Assets:				
Receivables:				
Members	\$ 284,565	\$ 5,492	\$ 19	\$ 290,076
Employers	296,374	22,807	-	319,181
Investment income	284,451	251	28	284,730
Investment proceeds	521,217	-	-	521,217
CMS Part D and prescriptions	-	-	16,615	16,615
Miscellaneous	589	552	151	1,292
Total Receivables	1,387,196	29,102	16,813	1,433,111
Investments, at fair value:				
Short-term	2,426,638	65,072	157,785	2,649,495
Fixed income	7,207,558	-	-	7,207,558
Common and preferred stock	9,357,122	-	-	9,357,122
Collective trust funds	10,460,482	-	-	10,460,482
Real estate	6,003,753	-	-	6,003,753
Alternative investments	12,862,439	-	-	12,862,439
Total Investments	48,317,992	65,072	157,785	48,540,849
Securities lending collateral pool	506,804	-	-	506,804
Capital assets (net of accumulated depreciation \$20,044)	22,333	-	-	22,333
Total Assets	50,234,325	94,174	174,598	50,503,097
Liabilities:				
Accounts payable and accrued expenses	106,413	314	1,571	108,298
Benefits payable	494,996	107	18,499	513,602
Participant premium advances	-	-	18,498	18,498
Investment purchases and other liabilities	592,316	-	-	592,316
Obligations under securities lending	506,804	-	-	506,804
Total Liabilities	1,700,529	421	38,568	1,739,518
Net assets held in trust for pension and postemployment healthcare benefits	\$ 48,533,796	\$ 93,753	\$ 136,030	\$ 48,763,579

The accompanying notes are an integral part of the financial statements.

FINANCIAL SECTION

Statements of Plan Net Assets June 30, 2012 and 2011 (Dollar Amounts in Thousands)

	2011			
	Pension	Postemployment Healthcare		Totals
		Premium Assistance	Health Options Program	
Assets:				
Receivables:				
Members	\$ 300,448	\$ 5,893	\$ 38	\$ 306,379
Employers	198,739	25,899	-	224,638
Investment income	314,822	242	11	315,075
Investment proceeds	313,512	-	-	313,512
CMS Part D and prescriptions	-	-	13,700	13,700
Miscellaneous	646	587	20	1,253
Total Receivables	1,128,167	32,621	13,769	1,174,557
Investments, at fair value:				
Short-term	5,586,933	80,587	145,901	5,813,421
Fixed income	8,527,633	-	-	8,527,633
Common and preferred stock	11,319,183	-	-	11,319,183
Collective trust funds	8,320,294	-	-	8,320,294
Real estate	5,263,467	-	-	5,263,467
Alternative investments	12,585,166	-	-	12,585,166
Total Investments	51,602,676	80,587	145,901	51,829,164
Securities lending collateral pool	761,805	-	-	761,805
Capital assets (net of accumulated depreciation \$18,208)	21,029	-	-	21,029
Total Assets	53,513,677	113,208	159,670	53,786,555
Liabilities:				
Accounts payable and accrued expenses	118,980	340	1,230	120,550
Benefits payable	646,390	100	19,525	666,015
Participant premium advances	-	-	16,986	16,986
Investment purchases and other liabilities	786,508	1,510	-	788,018
Obligations under securities lending	761,805	-	-	761,805
Total Liabilities	2,313,683	1,950	37,741	2,353,374
Net assets held in trust for pension and postemployment healthcare benefits	\$ 51,199,994	\$ 111,258	\$ 121,929	\$ 51,433,181

The accompanying notes are an integral part of the financial statements.

FINANCIAL SECTION

Statements of Changes in Plan Net Assets Years Ended June 30, 2012 and 2011 (Dollar Amounts in Thousands)

	2012			Totals
	Pension	Postemployment Healthcare		
		Premium Assistance	Health Options Program	
Additions:				
Contributions:				
Members	\$ 952,887	\$ -	\$ 213,642	\$ 1,166,529
Employers	1,004,584	81,343	-	1,085,927
Centers for Medicare & Medicaid Services	-	-	33,462	33,462
Total contributions	1,957,471	81,343	247,104	2,285,918
Investment income:				
From investing activities:				
Net appreciation (depreciation) in fair value of investments	539,129	(1,543)	-	537,586
Short-term	8,422	2,018	237	10,677
Fixed income	328,492	-	-	328,492
Common and preferred stock	258,258	-	-	258,258
Collective trust funds	5,209	-	-	5,209
Real estate	170,991	-	-	170,991
Alternative investments	255,769	-	-	255,769
Total investment activity income	1,566,270	475	237	1,566,982
Investment expenses	(481,234)	(52)	-	(481,286)
Net income from investing activities	1,085,036	423	237	1,085,696
From securities lending activities:				
Securities lending income	9,457	-	-	9,457
Securities lending expense	(1,174)	-	-	(1,174)
Net income from securities lending activities	8,283	-	-	8,283
Total net investment income	1,093,319	423	237	1,093,979
Total Additions	3,050,790	81,766	247,341	3,379,897
Deductions:				
Benefits	5,655,306	97,206	213,027	5,965,539
Refunds of contributions	24,675	-	-	24,675
Net transfer to State Employees' Retirement System	2,765	-	-	2,765
Administrative expenses	34,242	2,065	20,213	56,520
Total Deductions	5,716,988	99,271	233,240	6,049,499
Net increase (decrease)	(2,666,198)	(17,505)	14,101	(2,669,602)
Net assets held in trust for pension and postemployment healthcare benefits:				
Balance, beginning of year	51,199,994	111,258	121,929	51,433,181
Balance, end of year	\$ 48,533,796	\$ 93,753	\$ 136,030	\$ 48,763,579

The accompanying notes are an integral part of the financial statements.

FINANCIAL SECTION

Statements of Changes in Plan Net Assets Years Ended June 30, 2012 and 2011 (Dollar Amounts in Thousands)

	2011			Totals
	Pension	Postemployment Healthcare		
		Premium Assistance	Health Options Program	
Additions:				
Contributions:				
Members	\$ 1,042,707	\$ -	\$ 201,014	\$ 1,243,721
Employers	658,511	89,242	-	747,753
Centers for Medicare & Medicaid Services	-	-	32,080	32,080
Total contributions	1,701,218	89,242	233,094	2,023,554
Investment income:				
From investing activities:				
Net appreciation (depreciation) in fair value of investments	8,616,152	(1,324)	-	8,614,828
Short-term	12,755	2,063	310	15,128
Fixed income	383,306	-	-	383,306
Common and preferred stock	292,475	-	-	292,475
Collective trust funds	4,147	-	-	4,147
Real estate	113,370	-	-	113,370
Alternative investments	331,286	-	-	331,286
Total investment activity income	9,753,491	739	310	9,754,540
Investment expenses	(514,647)	(48)	-	(514,695)
Net income from investing activities	9,238,844	691	310	9,239,845
From securities lending activities:				
Securities lending income	8,251	-	-	8,251
Securities lending expense	(1,004)	-	-	(1,004)
Net income from securities lending activities	7,247	-	-	7,247
Total net investment income	9,246,091	691	310	9,247,092
Total Additions	10,947,309	89,933	233,404	11,270,646
Deductions:				
Benefits	5,281,223	93,518	214,967	5,589,708
Refunds of contributions	17,695	-	-	17,695
Net transfer to State Employees' Retirement System	9,844	-	-	9,844
Administrative expenses	37,028	1,988	18,729	57,745
Total Deductions	5,345,790	95,506	233,696	5,674,992
Net increase (decrease)	5,601,519	(5,573)	(292)	5,595,654
Net assets held in trust for pension and postemployment healthcare benefits:				
Balance, beginning of year	45,598,475	116,831	122,221	45,837,527
Balance, end of year	\$ 51,199,994	\$ 111,258	\$ 121,929	\$ 51,433,181

The accompanying notes are an integral part of the financial statements.

Notes to Financial Statements
Years Ended June 30, 2012 and 2011

1. Organization and Description of the System

(A) Organization

The System was established on July 18, 1917, under the provisions of Pamphlet Law 1043, No. 343 as a governmental cost-sharing multiple-employer plan that provides retirement allowances and other benefits to its members. Membership in the System is mandatory for nearly all qualifying public school employees in the Commonwealth of Pennsylvania (Commonwealth). At June 30, 2012, there were 773 participating employers, generally school districts. Membership as of June 30, 2011, the most recent year for which actual amounts are available, is presented in the table at the bottom of this page.

The Public School Employees' Retirement Board (Board) is established by state law as an independent administrative board of the Commonwealth. The Board exercises control and management of the System, including the investment of its assets. The Board has fifteen members including the Commonwealth's Secretary of Education, the State Treasurer, the Executive Director of the Pennsylvania School Boards Association, two members appointed by the Governor, six elected members (three from among the System's certified members, one from among the System's noncertified members, one from among the System's annuitants, and one from among school board members in Pennsylvania), two members from the Senate, and two members from the House of Representatives.

The State Treasurer is the custodian of the System's fund. The retirement plan of the System is a contributory defined benefit plan for which the benefit payments to members and contribution provisions by employers and employees are specified in the Pennsylvania Public School Employees' Retirement Code (Code). Changes in benefit and contribution provisions for the retirement plan must be made by legislation. Pursuant to state law, all legislative

bills and amendments proposing to change the System's retirement plan are to be accompanied with an actuarial note prepared by an enrolled pension actuary from the Public Employee Retirement Commission providing an estimate of the cost and actuarial effect of the proposed change.

Based upon criterion of financial accountability as defined by governmental accounting standards, the System is considered a component unit of the Commonwealth of Pennsylvania financial reporting entity and is included in the Comprehensive Annual Financial Report of the Commonwealth of Pennsylvania.

(B) Pension Plan

i. Pension Benefits

Under the provisions of the 1975 revision of the Code by the Pennsylvania General Assembly, members are eligible for monthly retirement benefits upon reaching (a) age 62 with at least 1 year of credited service; (b) age 60 with 30 or more years of credited service; or (c) 35 or more years of service regardless of age. Act 120 of 2010 (Act 120) preserves the benefits of existing members and introduced benefit reductions for individuals who become new members on or after July 1, 2011. Act 120 created two new membership classes, Membership Class T-E (Class T-E) and Membership Class T-F (Class T-F). To qualify for normal retirement, Class T-E and Class T-F members must work until age 65 with a minimum of 3 years of service or attain a total combination of age and service that is equal to or greater than 92 with a minimum of 35 years of service. The Internal Revenue Code (IRC) limitation on the annual benefits for a defined benefit plan was \$200,000 and age 62 for 2012 and \$195,000 and age 62 for 2011.

Benefits are generally equal to 2% or 2.5%, depending upon membership class, of the member's final average salary (as defined in the Code) multiplied by the number of

Currently employed members:		
Vested	191,879	
Nonvested	87,273	
Total currently employed members		279,152
Retirees and beneficiaries currently receiving benefits	194,622	
Inactive members and vestees entitled to but not receiving benefits	115,102	
Total retirees and other members		309,724
Total number of members		588,876

FINANCIAL SECTION

Notes to Financial Statements (continued)

PSERS members whose membership started prior to July 1, 2011:

Membership Class T-C	Active Members hired before July 22, 1983	5.25%
Membership Class T-C	Active Members hired on or after July 22, 1983	6.25%
Membership Class T-D	Active Members hired before July 22, 1983	6.50%
Membership Class T-D	Active Members hired on or after July 22, 1983	7.50%

PSERS members whose membership started on or after July 1, 2011 (Act 120 members):

Membership Class T-E*		7.50%
Membership Class T-F**		10.30%

* Shared risk program could cause future contribution rates to fluctuate between 7.5% and 9.5%

** Shared risk program could cause future contribution rates to fluctuate between 10.3% and 12.3%

years of credited service. For members whose membership started prior to July 1, 2011, in most cases after completion of five years of service, a member's right to the defined benefits is vested and early retirement benefits may be elected. For Class T-E and Class T-F members, the right to benefits is vested after ten years of service. Under certain features of the System, active members may purchase credit for various types of school and non-school service on a lump-sum, installment purchase basis, or through an actuarially calculated benefit reduction. Class T-E and Class T-F members must purchase Non Qualifying Part Time service and most other types of non-school or non-state service credit at full actuarial cost.

In addition to regular retirement benefits, the System also provides for disability retirement benefits and death benefits. Participants are eligible for disability retirement benefits after completion of five years of credited service. Such benefits are generally equal to 2% or 2.5%, depending upon membership class, of the member's final average salary (as defined in the Code) multiplied by the number of years of credited service, but not less than one-third of such salary nor greater than the benefit the member would have had at normal retirement age. Members over normal retirement age may apply for disability benefits. Certain exceptions apply to normal disability retirements.

Death benefits are payable upon the death of an active member who has reached age 62 or who has at least five years of credited service (ten years for Class T-E and Class T-F members). Such benefits are actuarially equivalent to the benefit that would have been effective if the member had retired on the day before death. Benefits may be distributed for a deceased member by a nonspouse beneficiary via a direct trustee-to-trustee transfer to an Individual Retirement Account (IRA), which is treated as an inherited account.

Members with credited service in the Commonwealth of Pennsylvania State Employees' Retirement System (SERS) may elect to transfer service with the Public School

Employees' Retirement System upon commencement of employment in the public school system. Similarly, a member with credited service in the System may transfer such service with SERS upon becoming a member of that system.

All members are fully vested in their individual balance in the Members' Savings Account which is described in Note 3. All non-vested members may receive a refund of their individual balance of member contributions and interest from the Members' Savings Account upon termination of public school employment. Vested members who enrolled prior to July 1, 2011 may elect to receive a return of their accumulated contributions and interest upon their retirement. Vested Class T-E and Class T-F members cannot withdraw their individual balance from the Members' Savings Account upon their retirement.

ii. Contributions

The contribution policy is set by the Code and requires contributions by active members, employers, and the Commonwealth. The System's funding policy provides for periodic employer and Commonwealth contributions at actuarially determined rates, expressed as a percentage of annual covered payroll, such that they, along with employee contributions and an actuarially determined rate of investment return, are adequate to accumulate assets to pay retirement benefits when due. Level percentage of payroll employer contribution rates are determined using the entry age normal actuarial funding method. This method determines the amount of contributions necessary to (1) fully fund all current costs, (also known as normal cost), which represents the estimated amount necessary to pay for the benefits earned by the employees during the current service year; and (2) liquidate the prior service cost for service earned prior to the current service year and subsequent benefit increases, which represents the amount necessary to fund accrued liabilities over the appropriate amortization periods.

Notes to Financial Statements (continued)

Contribution rates for active members are set by law (redefined with the provisions of Act 9 of 2001 and Act 120) and are dependent upon membership class. The contribution rates based on qualified member compensation for virtually all members are presented in the table at the top of this page. The IRC limitation on the annual compensation for a defined benefit plan was \$245,000 for 2011 and \$250,000 for 2012.

Active members enrolling prior to Act 120 newly hired after July 1, 2001, the effective date of Act 9 of 2001, are automatically Membership Class T-D (Class T-D). The contribution rates for all members in Class T-D were effective January 1, 2002. For Act 120 members, all new members will automatically become Class T-E members. New members however, will have a one-time opportunity to elect Class T-F within 45 days of receiving written notification from PSERS. Failure to elect Class T-F at time of original eligibility will make the member ineligible for Class T-F forever. Act 120 introduced a shared risk program that could affect Class T-E and Class T-F members' contribution rates in future fiscal years. With the shared risk program Class T-E and Class T-F members benefit when investments of the fund are doing well and share some of the risk when investments underperform. The member contribution rate will stay within the specified range allotted for Class T-E or Class T-F; but could increase or decrease by .5% every three years starting July 1, 2015, dependent on investment performance of PSERS. The member contribution rate will never go below the base rate of 7.5% for Class T-E and 10.3% for Class T-F members, or above 9.5% for Class T-E and 12.3% for Class T-F members.

The total contribution rate for the employers and the Commonwealth was 8.65% and 5.64% of qualified compensation for the years ended June 30, 2012 and 2011, respectively. The total contribution rate for the year ended June 30, 2011 was recertified from an actuarially required rate of 8.22% to 5.64% based upon the statutory requirements of Act 46 of 2010.

Act 120 suppresses the employer contribution rate by using rate caps in future years to keep the rate from rising too high, too fast for budgetary purposes.

The rate caps limit the amount the pension component of the employer contribution rate can increase over the prior year's rate as follows:

- FY 2012 - not more than 3.0% plus the premium assistance contribution rate
- FY 2013 - not more than 3.5% plus the premium assistance contribution rate

- FY 2014 and thereafter - not more than 4.5% plus the premium assistance contribution rate

The rate cap remains at 4.5% until the rate cap no longer applies, i.e. the rise in the employer contribution rate is less than the rate cap in effect at that time. Once the rate caps no longer apply, the employer normal cost becomes the contribution rate floor.

According to requirements established in Act 29 of 1994, the Commonwealth reimburses school entity employers a portion of the employer contributions paid to the System. All school entity employers are reimbursed by the Commonwealth at least 50% of the total employer contributions based on the total contribution rate. The Commonwealth reimburses certain school entity employers at a rate greater than 50% based upon non-pension criteria which stipulate that the entity must have a Commonwealth Department of Education calculated Market Value / Personal Income Aid Ratio in excess of .5000. The Commonwealth remits employer contributions for employers other than school entities directly to the System. All contributions from employers and the Commonwealth are shown as employer contributions on the Statements of Changes in Plan Net Assets.

A portion of each employer and Commonwealth contribution to the System is set aside for the funding of the Health Insurance Premium Assistance (PA) Program. The PA Program contribution rate is set at a level necessary to establish reserves sufficient to provide PA Program payments for all participating eligible members for the subsequent fiscal year. The portion of the total contribution rate for employers and the Commonwealth used to fund the PA Program was 0.65% and 0.64% for the years ended June 30, 2012 and 2011, respectively.

iii. Funding Status and Annual Required Contributions (ARC)

As of June 30, 2011, the most recent actuarial valuation, the plan was 69.1% funded. The actuarial accrued liability for pension benefits was \$85.6 billion, and the actuarial value of pension assets was \$59.1 billion, resulting in an unfunded accrued liability of \$26.5 billion. The covered payroll of active members was \$12.9 billion and the ratio of the unfunded actuarial accrued liability to the covered payroll was 205.3%.

For fiscal year ended June 30, 2012, the ARC was \$2.63 billion. The actual employer contributions, net of purchase of service contributions, for fiscal year ended June 30, 2012 was \$1.0 billion resulting in a 38% contributed rate.

Notes to Financial Statements (continued)

The Schedule of Funding Progress and Schedule of Employer Contributions included as Required Supplementary Information following the notes to the financial statements provide multiyear presentations of funding status and ARC to illustrate their trends over time.

iv. Actuarial Assumptions and Methods**(a) Funding Method**

For purposes of determining pension contributions under the PSERS Code, the entry-age normal actuarial cost method is used in determining benefit liabilities and normal cost. Act 120 modified the funding method. The outstanding balance of the unfunded accrued liability as of June 30, 2010 was re-amortized over a 24 year period with amortization payments based on level percentage of pay. Future valuation experience gains or losses, and changes in the unfunded accrued liability resulting from changes in actuarial assumptions and methods, are amortized over a 24-year period as a level percent of pay. Future increases in accrued liability enacted by legislation after June 30, 2010 will be funded over a 10-year period as a level percent of pay.

For purposes of determining the annual required contributions under GASB Statement No. 25, the same funding method is used as for pension funding, except that (i) the 4% pension floor is not taken into account and (ii) the amortization payment will be set equal to the level dollar amount that will amortize the unfunded accrued liability over a period of 30 years.

(b) Asset Valuation Method

For actuarial purposes, Act 120 extended the asset smoothing from five years to ten years. Assets are valued using a ten-year moving market average value that will recognize the actuarial expected investment return immediately and spread the difference between actual and expected investment return beginning with fiscal year ended June 30, 2010 over a period of ten years (the averaging period is being phased-in from fiscal year 2006). Previously, PSERS recognized the actuarial expected return immediately and spread the difference between actual and expected investment return over a period of five years.

(c) Actuarial Assumptions

Significant actuarial assumptions employed by the actuary for funding purposes as of June 30, 2011, the date of the most recent actuarial valuation include:

- Investment return - 7.50%, includes inflation at 3.00%
- Salary increases - 5.50%, which reflects an allowance for inflation of 3.00%, real wage growth of 1%, and merit or seniority increases of 1.50%
- Amortization method - level percent of pay
- Benefit payments - no postretirement benefit increases assumed in the future
- Multiple decrement tables - mortality, vesting, retirement age, and withdrawal estimates are based upon tables provided by the actuary

The System's actuarial liabilities are calculated separately for retirees and beneficiaries and for active and inactive members. The actuarial present value of benefits to be paid to retirees and beneficiaries currently receiving benefits and deferred survivor beneficiaries, whose benefits have been determined, is calculated using the assumptions noted above. The Annuity Reserve Account with interest credited thereon at an annual rate of 5.50% is compared to the actuarial accrued liability for the remaining lifetimes of the retirees and beneficiaries and any deficiency is then funded by a transfer from the State Accumulation Account.

The actuarial accrued liability for active and inactive members is calculated on the projected benefit basis using the entry-age normal actuarial cost method under which the present value of each member's expected benefit payable at retirement or death is determined. The assets of the Members' Savings Account, State Accumulation Account and the fair value adjustment are subtracted from this present value to arrive at the funded or unfunded actuarial accrued liability.

(C) Postemployment Healthcare Plans**i. Health Insurance Premium Assistance Program****(a) Premium Assistance Benefits**

The System provides a Health Insurance Premium Assistance (PA) Program for all eligible annuitants who qualify or elect to participate. Under this program, employer contribution rates for the PA Program are established to provide reserves in the Health Insurance Account that are sufficient for the payment of PA Program benefits for each succeeding year. Effective January 1, 2002, under the provisions of Act 9 of 2001, participating eligible annuitants are entitled to receive premium assistance payments equal to the lesser of \$100 per month or their out-of-pocket monthly health insurance premium. To receive premium assistance, eligible annuitants must obtain their health insurance through either their school

Notes to Financial Statements (continued)

employer or the PSERS' Health Options Program. As of June 30, 2012 there were no assumed future benefit increases to participating eligible annuitants in the PA Program.

(b) Funding Status and Annual Required Contributions

As of June 30, 2011, the most recent actuarial valuation, the plan was 8.3% funded. The actuarial accrued liability for benefits was \$1.339 billion, and the actuarial value of assets was \$111.3 million, resulting in an unfunded accrued liability of \$1.228 billion. The covered payroll of active members was \$12.9 billion and the ratio of the unfunded actuarial accrued liability to the covered payroll was 9.5%.

For fiscal year ended June 30, 2012, the ARC was \$102.1 million. The actual employer contributions for fiscal year ended June 30, 2012 was \$80.9 million resulting in a 79.0% contributed rate.

The Schedule of Funding Progress and Schedule of Employer Contributions included as Required Supplementary Information following the notes to the financial statements provide multiple year presentations of funding status and ARC to illustrate their trends over time.

(c) Actuarial Assumptions and Methods

The health insurance liability and funding provisions of the PSERS Code differ from the GASB disclosure requirements. As a result, there are different determinations of actuarial liability and contribution requirements for GASB accounting purposes and for Commonwealth funding purposes. For purposes of funding, the actuarial liability equals the assets in the PA Program account, and the contribution required is the amount necessary to establish reserves sufficient to provide PA Program payments to all participating eligible annuitants during the fiscal year that immediately follows the year the employer contribution is made. For GASB accounting purposes, the actuarial liability has been determined under the entry age normal actuarial cost method, and the ARC is equal to the entry age normal cost for health insurance plus an amount that will amortize the entry age unfunded actuarial liability for health insurance over a period of 30 years using level dollar open amortization. The entry age actuarial cost method was selected for this calculation because it meets the GASB parameters for determining actuarial liability and normal cost, and is the cost method specified by the PSERS Code for the PSERS pension plan.

Each annual actuarial valuation for the PA Program includes calculations that are based on the PA benefits provided under the terms of the substantive plan in effect at the time of each valuation. The valuations involve estimates of the value of reported amounts and assumptions about the probability of events far into the future. The actuarial calculations for the PA Program reflect a long-term perspective. Actuarially determined amounts are subject to continual revision as results are compared to past expectations and new estimates are made about the future. Other significant actuarial assumptions employed by the actuary as of June 30, 2011, the date of the most recent actuarial valuation were:

- Investment return - 7.50%, includes inflation at 3.00%
- Salary increases - 5.50%, which reflects an allowance for inflation of 3.00%, real wage growth of 1%, and merit or seniority increases of 1.50%
- Multiple decrement tables - mortality, vesting, retirement age, and withdrawal estimates are based upon tables provided by the actuary

ii. Health Options Program

The Health Options Program (HOP) is a PSERS-sponsored voluntary health insurance program for the sole benefit of annuitants of PSERS, spouses of annuitants, survivor annuitants and their dependents who participate in HOP. The HOP is funded exclusively by the premiums paid by its participants for the benefit coverage they elect. HOP offers several health plans. Participants may select among a self-funded Medicare supplement plan, two Medicare Rx plans, and multiple Medicare Advantage plans for those eligible for Medicare. Participants not eligible for Medicare have a choice of a self-funded high deductible indemnity plan and multiple managed care plans. Medicare Advantage and managed care plans are available to retirees residing in the plan's service area. The Medicare Advantage and managed care plans are provided by private insurance companies or managed care organizations and benefits are fully insured. The Medicare supplement and high deductible plans are self-funded and claims are adjudicated by a third party administrator. The Medicare Rx Options and the prescription drug benefit of the high deductible plan for those not eligible for Medicare are also self-funded and HOP uses a pharmacy benefits manager to administer the benefits. Effective January 1, 2006, PSERS entered into an Employer/Union Entity contract with the Centers for Medicare and Medicaid Services (CMS) to operate a voluntary Medicare Prescription Drug Plan (PDP). Monthly contributions are received from CMS covering the 49,674 participants in the PDP. An independent

Notes to Financial Statements (continued)

actuarial consulting firm sets the rates for the self-funded benefits. The HOP maintains reserves for claims that are incurred but not reported (IBNR) and for claim fluctuation for the self-funded benefit plans. At June 30, 2012 and 2011 PSERS recorded \$14,389,000 and \$15,394,000, respectively, in IBNR. The IBNR is included in benefits payable. The PSERS pension fund assets are not available to fund or satisfy obligations of the HOP.

2. Summary of Significant Accounting Policies**(A) Basis of Accounting**

The financial statements of the System are prepared on the accrual basis of accounting under which expenses are recorded when the liability is incurred, revenues are recorded in the accounting period in which they are earned and become measurable, and investment purchases and sales are recorded as of their trade date. Member and employer contributions are recognized in the period for which employees' salaries are reported. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

The accounting and reporting policies of the System conform to accounting principles generally accepted in the United States of America (GAAP). The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of additions and deductions in plan net assets during the reporting period. Actual results could differ from those estimates.

(B) Investments

The System's investments are reported at fair value. Fair value is the amount that the System can reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller, that is, other than in a forced or liquidation sale. Short-term securities are carried at cost, which approximates fair value, unless they have published market prices or quotations from national securities exchanges or securities pricing services, in which case they are valued at the published market price. Fixed income securities and common and preferred stocks are generally valued based on published market prices and quotations from national securities exchanges or securities pricing services. Securities which are not traded on a national securities exchange are valued by the respective fund manager or other third parties based on similar sales.

Directly-owned real estate investments are primarily valued based on appraisals performed by independent appraisers and, for properties not appraised, the present value of the projected future net income stream is used. Real estate owned investments are reported net of related debt borrowed against the market value of the property. As of June 30, 2012 and 2011, \$132,000,000 in line of credit advances were netted against the related property valuation. The line of credit balance is due on March 9, 2015. The line is payable at an interest rate equivalent to the lender's commercial paper rate plus 75 basis points and is collateralized by certain fixed income investments of the System.

For alternative investments which include private equity, private debt, venture capital and equity real estate investments where no readily ascertainable market value exists, management, in consultation with the general partner and investment advisors, has determined the fair values for the individual investments based upon the partnership's most recent available financial information. Futures contracts, foreign exchange contracts, and options are marked-to-market daily based on published market prices and quotations from national securities exchanges or securities pricing services. The changes in market value are recognized as part of net appreciation/depreciation in the fair value of investments. Initial margin requirements for such financial instruments are provided by investment securities pledged as collateral or by cash.

Collective trust fund investments (CTF) consist primarily of domestic and international institutional funds. The funds generally do not pay interest or dividends to shareholders and reinvest all income earned on securities held by the fund. The fair value of CTF is based on the reported share value of the respective fund. CTF are managed by state chartered banks for which various state banking departments have regulatory oversight and investment advisors for which regulatory agencies such as the Securities and Exchange Commission have regulatory oversight. Investments that are not subject to this oversight are subject to annual independent audits.

In accordance with PSERS' investment guidelines, cash collateral from securities loaned is invested in one of two collateral investment pools, the first of which is denominated in U.S. dollars (USD) and the second in Euros. The USD pool is invested entirely in overnight repurchase agreements carried at amortized cost which approximates fair value. The Euro pool is invested in asset-backed floating rate notes which are marked-to-market daily based on published market prices and quotations from national securities exchanges or securities pricing

Notes to Financial Statements (continued)

services. In addition to the floating rate notes, the Euro pool is invested in repurchase agreements.

Investment expenses consist of investment manager fees and those administrative expenses directly related to the System's investment operations. Unsettled investment sales are reported as investment proceeds receivable and unsettled investment purchases are included in investment purchases and other liabilities.

(C) Capital Assets

Capital assets consist primarily of data processing equipment and software and internally developed computer software qualifying as intangible assets according to GASB 51. Capital assets other than intangible assets are depreciated using the straight-line method over an estimated useful life of five years. The System amortizes intangible assets using the straight-line method over an estimated useful life of twenty years.

(D) Benefits Payable

Benefits payable identifies the obligations of the System, on an accrual basis, at the end of the fiscal year. It includes the estimated retirement and death benefits payable, premium assistance benefits payable, and the HOP IBNR claims for its participants.

(E) Compensated Absences

The System uses the accrual basis of accounting for measuring vacation leave, sick leave, and other compensated absences liabilities. Employees of the System are paid for accumulated vacation leave upon termination or retirement. Retiring employees of the System that meet service, age, or disability requirements are paid between 30% and 100% of sick days available at retirement, up to 163 maximum days paid. As of June 30, 2012 and 2011, \$3,452,000 and \$3,378,000, respectively, was accrued for unused vacation and sick leave for the System's employees and included in "Accounts payable and accrued expenses" on the Statements of Plan Net Assets.

(F) Participant Premium Advances

Premium advances in the fiscal years ended June 30, 2012 and 2011 are for HOP premiums related to health care coverage to be provided in calendar year 2012 and 2011, respectively.

(G) Federal Income Taxes

The Internal Revenue Service (IRS) issued a determination letter dated March 3, 1978 which stated that the plan

and its underlying trust qualify under the provisions of Section 501(a) of the Internal Revenue Code (IRC) and therefore are exempt from federal income taxes. The plan has been amended since receiving that determination letter. Additionally, the IRS issued a 1982 ruling which concluded that the fund and the board are integral parts of the Commonwealth, and are therefore not subject to federal income tax. In the opinion of management, the System has operated within the terms of the plan and remains qualified under the applicable provisions of the IRC.

(H) Risk Management

The System is exposed to various liabilities and risks of loss, including, without limitation, the ordinary risks of investment losses, risks related to theft or destruction of assets, liabilities resulting from injuries to employees, and liabilities resulting from court challenges to fiduciary decisions. As an administrative agency of the Commonwealth of Pennsylvania, the System is accorded sovereign immunity. For claims not shielded by sovereign immunity, the System participates in certain Commonwealth pooled insurance programs and requires asset managers to carry certain insurance coverage for the protection of the System. The System has implemented a self-insurance program for fiduciary and director and officer liability coverage. During the past three fiscal years, insurance settlements did not exceed insurance coverage.

(I) Reclassifications

Certain 2011 amounts have been reclassified in conformity with the 2012 presentation. These reclassifications had no effect on net assets held in trust for pension benefits or the change in plan net assets.

(J) Members Receivables

Members receivables include an amount for members' obligations to the System for the purchase of service credit. Members have a variety of options to remit purchase of service payments:

- Remit a lump sum payment.
- Request an installment plan from one to seven years where the member's employer establishes a payroll deduction process. The member's employer then forwards monthly payments of the withheld amounts to PSERS.
- Accept an actuarial reduction debt through which the amount of the purchase plus accumulated interest will reduce the member's retirement or death benefit.
- Rollover funds from an eligible distribution.

Notes to Financial Statements (continued)

The following is a summary of the members receivables at June 30, 2012 and 2011:

	(Dollar Amounts in Thousands)	
	2012	2011
Pension:		
Member contributions	\$ 76,202	\$ 80,117
Purchase of service	202,271	212,431
Other	6,092	7,900
Total Members Receivable	<u>\$ 284,565</u>	<u>\$ 300,448</u>

(K) Adoption of New Accounting Standards

During the year ended June 30, 2011 the System adopted GASB Statement No. 59, *Financial Instruments Omnibus*, which was issued to update and improve existing standards regarding financial reporting and disclosure requirements of certain financial instruments.

In June 2011 GASB issued GASB Statement No. 64 (GASB 64), *Derivative Instruments: Application of Hedge Accounting Termination Provisions – an amendment of GASB Statement No. 53*. GASB 64 became effective during FY 2012 and was issued to provide government entities guidance to enhance comparability and improve financial reporting by clarifying the circumstances in which hedge accounting should continue when a swap counterparty or a swap counterparty’s credit support provider is replaced. Upon examination of the provisions of GASB 64, it was determined to have no current impact on PSERS.

3. Description of Accounts

The Code requires the System to maintain the following accounts which represent reserves held for future and current benefit payments as follows:

	(Dollar Amounts in Thousands)	
	2012	2011
Pension:		
State Accumulation Account	\$ (13,746,778)	\$ (5,704,296)
Members’ Savings Account	12,535,442	12,242,308
Annuity Reserve Account	49,745,132	44,661,982
	<u>\$ 48,533,796</u>	<u>\$ 51,199,994</u>
Postemployment healthcare:		
Health Insurance Account	\$ 93,753	\$ 111,258
Health Insurance Program Account	136,030	121,929
	<u>\$ 229,783</u>	<u>\$ 233,187</u>

(A) State Accumulation Account

The State Accumulation Account is credited with the contributions of the Commonwealth and the employers. Additionally, interest earnings of the System (after crediting the Members’ Savings Account with 4% interest and the reserve for retirement with 5.50% statutory interest) are credited to this account. Each year, the necessary amounts, as determined by the actuary for the payment of retirement, disabilities, and death benefits, are transferred from the State Accumulation Account to the Annuity Reserve Account increasing the reserve credit to the 7.50% valuation assumption rate determined by the actuary. All administrative expenses necessary for the operation of the System, except for premium assistance and HOP expenses, are paid from the State Accumulation Account.

(B) Members’ Savings Account

The Members’ Savings Account is credited with all contributions made by active members of the System. Interest is added to the member’s individual account at an annual rate of 4%.

Upon death or retirement of a member, the accumulated contributions plus interest are transferred to the Annuity Reserve Account for subsequent payment of benefits.



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Notes to Financial Statements (continued)

(C) Annuity Reserve Account

The Annuity Reserve Account represents the amounts transferred from the Members' Savings and State Accumulation Accounts, plus additional contributions made by the Commonwealth and employers for the payment of supplemental annuities and cost-of-living increases. All death, disability, and retirement benefits are paid from this account. Annual interest of 5.50% is credited to the Annuity Reserve Account.

(D) Health Insurance Account

The Health Insurance Account is credited with contributions of the Commonwealth and the employers for the PA Program. Effective January 1, 2002, under the provisions of Act 9 of 2001, participating eligible annuitants are entitled to receive premium assistance payments equal to the lesser of \$100 per month or their out-of-pocket monthly health insurance premium. The Health Insurance Account pays all administrative expenses necessary to operate the health insurance premium assistance program.

(E) Health Insurance Program Account

The Health Insurance Program Account is credited with contributions from members of the HOP and from CMS. All benefits related to the HOP (premium payments to the insurance companies and self-funded benefits) are paid from this account. The Health Insurance Program Account pays all administrative expenses necessary to operate the HOP.

4. Investments

(A) Summary of Investments

The Board has the responsibility to invest and reinvest available funds of the System in accordance with the guidelines and limitations set forth in the Code and other applicable state law. The Board accomplishes the daily management of the System's investments through investment advisors who act as agents for the System and through internal investment managers.

The Board invests the funds of the System using the Prudent Investor Standard, as articulated in the Code, which means "the exercise of that degree of judgment, skill and care under the circumstances then prevailing which persons of prudence, discretion and intelligence who are familiar with such matters exercise in the management of their own affairs not in regard to speculation, but in regard to the permanent disposition of the fund, considering the probable income to be derived therefrom as well as the probable safety of their capital." The Board has adopted its investment policy to formally document investment objectives and responsibilities. This policy, as well as applicable state law, establishes guidelines for permissible investments of the System.



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FINANCIAL SECTION

Notes to Financial Statements (continued)

A summary of the fair value of investments at June 30, 2012 and 2011 follows:

	(Dollar Amounts in Thousands)	
	2012	2011
Pension investments:		
Short-term:		
PSERS Short-Term Investment Fund	\$ 1,678,876	\$ 4,474,903
Other domestic short-term	527,008	758,775
International short-term	220,754	353,255
	2,426,638	5,586,933
Fixed income:		
Domestic asset-backed and mortgage-backed securities	2,580,131	3,418,696
U.S. government and agency obligations	1,961,606	1,773,700
Domestic corporate and taxable municipal bonds	1,426,219	1,724,004
International fixed income	1,239,602	1,611,233
	7,207,558	8,527,633
Common and preferred stock:		
Domestic common and preferred stock	5,056,850	5,532,057
International common and preferred stock	4,300,272	5,787,126
	9,357,122	11,319,183
Collective trust funds	10,460,482	8,320,294
Real estate:		
Equity real estate	5,767,203	5,036,219
Directly-owned real estate	236,550	227,248
	6,003,753	5,263,467
Alternative investments:		
Private equity	8,054,170	7,813,079
Private debt	3,918,894	3,922,952
Venture capital	889,375	849,135
	12,862,439	12,585,166
Pension investments at fair value	\$ 48,317,992	\$ 51,602,676
Postemployment healthcare investments:		
Premium Assistance Program:		
PSERS Short-Term Investment Fund	\$ 21,995	\$ 24,300
Other domestic short-term	43,077	56,287
	65,072	80,587
Health Options Program:		
PSERS Short-Term Investment Fund	88,197	87,977
Other domestic short-term	69,588	57,924
	157,785	145,901
Postemployment healthcare investments at fair value	\$ 222,857	\$ 226,488

Notes to Financial Statements (continued)**(B) Deposit and Investment Risk Disclosures****i. Deposits**

Custodial credit risk for deposits is the risk that, in the event of a financial institution failure, the System would not be able to recover the value of the deposits. The Commonwealth's Treasury Department is the custodian of the System's funds. Commonwealth Treasury Department deposits must be held in insured depositories approved by the Commonwealth's Board of Finance and Revenue and must be fully collateralized.

The System, through its third party administrator, maintains certain bank deposits for the operation of its voluntary HOP. These deposits are not required to be collateralized by statute or policy. These deposits totaled \$69,588,000 and \$57,924,000 at June 30, 2012 and 2011, respectively, and are under the custody of M&T Bank which has an A-rating by Standard and Poor's (S&P) and an A3 rating by Moody's Investor Services (Moody's).

ii. Investment Risks

The System's investments, including derivatives and other similar investments, may be subject to various risks. Among these risks are concentration of credit risk, custodial credit risk, credit risk, interest rate risk, and foreign currency risk. The policies addressing each one of these risks, discussed in more detail below, are contained within the Investment Policy Statement, Objectives, and Guidelines reviewed and approved annually by the Board. Due to the level of risk associated with certain investments, it is possible that changes in the values of investments may occur in the near term and that such changes could materially affect the amounts reported in the Statements of Plan Net Assets.

(a) Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributed to the magnitude of the System's investment in a single issuer. As of June 30, 2012 and 2011 the System had no single issuer that exceeded 5% of total investments. Investments issued or explicitly guaranteed by the U.S. government and investments in mutual funds, external investment pools, and other pooled investments were excluded.

(b) Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the System would not be able to recover the value of investment or collateral securities that are in the possession of an outside party. In accordance with a contractual relationship between

the Commonwealth's Treasury Department and its custodial agent, substantially all investments, where securities are used as evidence of the investment, are held by the custodian in book-entry form in the System's name. Those investments are defined as insured or registered investments for which the securities are held by the System or its agent and, therefore, have a very minimal level of custodial credit risk. The remaining investments, which do not have securities that are used as evidence of the investment, are primarily in collective trust funds and limited partnerships, which include real estate and alternative investments.

(c) Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The credit risk of a debt instrument is measured by nationally recognized statistical rating organizations (NRSRO) such as Fitch Investor Services (Fitch), Moody's, and S&P. Annually, the Board establishes an asset allocation plan. This plan manages the overall credit risk of the fixed income asset class through a clearly defined long-term asset allocation policy. This policy establishes a long-term target allocation of the fixed income asset class at 26.2% of the investment portfolio. The fixed income target allocation consists of:

- An allocation of 5.2% of the portfolio has been made to the U.S. core plus segment of the fixed income asset class benchmarked to the Barclays Capital U.S. Aggregate Index. The U.S. core plus allocation is composed of primarily investment grade, relatively liquid, public domestic bonds with an overall weighted-average NRSRO credit rating of A or better.
- An allocation of 6.0% of the portfolio has been made to the high yield segment of the fixed income asset class benchmarked to the Barclays Capital U.S. High Yield Index. The high yield allocation is composed of less liquid public non-investment grade fixed income securities with an overall weighted-average NRSRO credit rating of B- or better.
- An allocation of 5.0% of the portfolio has been made to the Treasury Inflation-Protected Securities (TIPS) segment of the fixed income asset class benchmarked to the Barclays Capital U.S. TIPS Index and composed of primarily government issued TIPS with an overall weighted-average NRSRO credit rating of AA or better. The portfolio manager is permitted to leverage the portfolio using TIPS total return swaps up to 3:1.
- An allocation of 3.0% of the portfolio has been made to the non-U.S. developed markets fixed income asset class benchmarked to the Barclays Capital Global Aggregate GDP-weighted Developed Market ex-U.S.

Notes to Financial Statements (continued)

(Unhedged) Index composed of primarily investment grade, relatively liquid non-U.S. public bonds with an overall weighted-average NRSRO credit rating of A or better.

- An allocation of 2.0% of the portfolio has been made to the emerging markets fixed income asset class benchmarked to the Barclays Capital EM Local Currency-Government-MV Weighted (Unhedged) -10% Country Cap Index composed of primarily investment grade, relatively liquid non-U.S. public bonds with an overall weighted-average NRSRO credit rating of BB- or better.
- An allocation of 5.0% of the portfolio has been made to cash benchmarked to the Merrill Lynch U.S. Treasury Bill 0-3 Months Index composed of primarily investment grade, relatively liquid U.S. and non-U.S. public bonds with an overall weighted-average NRSRO credit rating of AA or better.

The following table discloses aggregate market value by credit quality rating category. Many securities have ratings from more than one NRSRO and sometimes those ratings differ from one NRSRO to another. The data listed below uses the rating (expressed as S&P equivalent) available from Fitch, Moody's and/or S&P that indicates the lowest credit quality at June 30, 2012 and 2011.

Quality Rating	(Dollar Amounts in Thousands)	
	2012 Fair Value	2011 Fair Value
AAA	\$ 764,417	\$ 1,397,723
AA	473,928	489,305
A	705,148	1,063,433
BBB	702,523	844,735
BB and Below	971,777	1,222,225
NR*	8,055,914	5,183,904
Total Exposed to Credit Risk	11,673,707	10,201,325
US Government Guaranteed**	3,638,615	8,342,563
Total Fixed Income and Short-Term Investments	\$ 15,312,322	\$ 18,543,888

* Not Rated securities include \$5,455,269 and \$4,202,834 in collective trust funds at June 30, 2012 and 2011 respectively.

** Comprised of U.S. government and agency obligations explicitly guaranteed by the U.S. government and not considered to have credit risk.

For derivatives exposed to credit risk, the table below presents aggregate market value by the least favorable credit rating provided by NRSROs at June 30, 2012 and 2011.

Quality Rating	(Dollar Amounts in Thousands)	
	2012 Fair Value	2011 Fair Value
AA	\$ (11,394)	\$ 29,005
A	(11,866)	(211)
Total Swaps - Total Return	\$ (23,260)	\$ 28,794

(d) Interest Rate Risk

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of a fixed income investment. The System manages its interest rate risk by diversifying the fixed income portfolio and maintaining the fixed income portfolio at a Board-approved effective duration range of the benchmark index.

Duration is a measure of the approximate sensitivity of a bond's value to interest rate changes. The higher the duration, the greater the changes in fair value when interest rates change. For example, a duration of 4.0 would mean that, given a 100-basis point change up/down in rates, a bond's price would move down/up approximately 4.0 percent. PSERS measures interest rate risk using option-adjusted duration, which recognizes the fact that yield changes may change the expected cash flows due to embedded options.



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FINANCIAL SECTION

Notes to Financial Statements (continued)

At June 30, 2012 and 2011, the System's fixed income portfolio had the following option-adjusted durations by fixed income sector:

Investment Type	(Dollar Amounts in Thousands)			
	2012		2011	
	Option-Adjusted Duration	Fair Value	Option-Adjusted Duration	Fair Value
Domestic asset-backed and mortgage-backed securities	1.0	\$ 2,580,131	1.3	\$ 3,418,696
U.S. government and agency obligations	6.9	1,961,606	5.7	1,773,700
Domestic corporate and taxable municipal bonds	0.6	1,426,219	3.4	1,724,004
International fixed income	4.0	1,239,602	4.3	1,611,233
Collective trust funds	4.3	5,455,269	3.8	1,131,686
PSERS Short-Term Investment Fund	0.1	1,789,068	0.1	4,587,180
Total	3.1 *	\$ 14,451,895	2.4*	\$ 14,246,499

* Fixed income investment managers enter into futures contracts to adjust the durations of their portfolios as a whole rather than any particular investment type within the portfolio. In total, the futures contracts have adjusted PSERS' total portfolio duration upward by 0.1 at June 30, 2012 and 2011. The total portfolio option-adjusted duration is calculated by weighting each investment type by fair value.



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FINANCIAL SECTION

Notes to Financial Statements (continued)

(e) Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment. As part of the System's program to manage risk and enhance returns, the System invests in non-U.S. markets. Investment managers in non-U.S. equity and global fixed income may hedge their non-U.S. foreign currency exposure back to U.S. dollars. At June 30, 2012 and 2011 PSERS had the following non-U.S. currency exposures:

2012						
(Dollar Amounts in Thousands)						
Currency	Equity	Fixed Income	Alternative Investments & Real Estate	Short-Term*	Total Fair Value	
Euro	\$ 573,763	\$ 171,451	\$ 2,420,337	\$ (629,843)	\$ 2,535,708	
Japanese yen	675,615	53,696	-	73,113	802,424	
British pound sterling	772,071	36,716	24,171	(139,358)	693,600	
Canadian dollar	359,569	22,974	269	17,386	400,198	
Australian dollar	264,528	-	-	(39,707)	224,821	
Hong Kong dollar	210,518	-	-	210	210,728	
Brazil real	52,874	65,855	-	75,055	193,784	
South African rand	64,243	43,544	-	72,791	180,578	
New Turkish lira	37,238	39,922	-	101,023	178,183	
Mexican new peso	10,288	67,619	-	52,407	130,314	
South Korean won	72,610	42,477	-	(1,328)	113,759	
Norwegian krone	39,774	2,906	-	70,461	113,141	
Polish zloty	7,660	36,509	-	62,622	106,791	
Other non-U.S. currencies	713,324	197,579	-	(438,917)	471,986	
Total	\$ 3,854,075	\$ 781,248	\$ 2,444,777	\$ (724,085)	\$ 6,356,015	

2011						
(Dollar Amounts in Thousands)						
Currency	Equity	Fixed Income	Alternative Investments & Real Estate	Short-Term*	Total Fair Value	
Euro	\$ 869,631	\$ 283,457	\$ 2,700,941	\$ (42,624)	\$ 3,811,405	
British pound sterling	1,037,285	28,124	7,905	(83,210)	990,104	
Japanese yen	888,939	59,028	-	19,296	967,263	
Canadian dollar	570,515	17,855	2,163	(32,757)	557,776	
Australian dollar	387,318	6,982	-	130,042	524,342	
Brazil real	103,195	57,054	-	145,027	305,276	
Hong Kong dollar	254,608	-	-	176	254,784	
Swiss franc	334,961	-	-	(96,720)	238,241	
South African rand	65,946	49,997	-	116,948	232,891	
Indian rupee	67,743	-	-	138,855	206,598	
Indonesian rupiah	39,246	47,443	-	80,196	166,885	
Norwegian krone	30,641	3,808	-	131,625	166,074	
South Korean won	102,798	7,550	-	53,188	163,536	
Other non-U.S. currencies	558,614	331,305	-	14,558	904,477	
Total	\$ 5,311,440	\$ 892,603	\$ 2,711,009	\$ 574,600	\$ 9,489,652	

* Includes investment receivables and payables

Notes to Financial Statements (continued)

<u>Currency</u>	(Dollar Amounts in Thousands)	
	2012	2011
	<u>Notional Value</u>	<u>Notional Value</u>
British pound sterling	\$ 82,410	\$ 122,723
Japanese yen	60,038	102,741
Euro	63,260	30,072
Canadian dollar	29,455	36,761
Australian dollar	22,457	9,161
Total Futures Contracts and Total Return Swaps	\$ 257,620	\$ 301,458

At June 30, 2012 and 2011, the System had foreign currency exposures for its derivatives (except for foreign exchange contracts which are included in Note 5) as presented in the table at the top of the page.

(C) Securities Lending

In accordance with a contract between the Commonwealth and its custodial agent, the System participates in a securities lending program. Under this program, the custodian, acting as the lending agent, loans securities (equities, fixed income and money market instruments) to independent brokers and dealers in exchange for collateral in an amount not less than 102% of the fair value of any securities loaned except for non-U.S. corporations for which 105% of the fair value is required. For Euro fixed income debt issues, for which the Commonwealth receives Euros as collateral and international fixed income debt issues denominated in U.S. dollars, the collateral required to be exchanged is in an amount not less than 102% of the fair value of any securities loaned. Collateral is marked-to-market daily. If the fair value of the collateral held falls below the minimum guidelines for securities loaned, additional collateral is obtained. In lieu of certain approved securities or cash, the borrower may deliver to the lending agent irrevocable bank letters of credit as collateral. If the collateral obtained consists in whole or in part of cash, the lending agent may use or invest the cash in accordance with reinvestment guidelines approved by the System.

As of June 30, 2012 and 2011, the System had no credit risk exposure to borrowers because the amounts the System owed the borrowers exceeded the amounts the borrowers owed the System. Under the securities lending program, the lending agent provides indemnification to the Commonwealth if the same borrowers fail to return the underlying securities (and the collateral is inadequate to replace the loaned securities) or fail to pay income distributions on them. There were no losses during the fiscal years ended June 30, 2012 and 2011, resulting from a default of the borrowers or the lending agent.

All securities loans can be terminated on demand by either the System or the borrower, although the average term of the loan is one day. There were no term loans as of June 30, 2012 and 2011.

Cash collateral is invested in one of two short-term collateral investment pools, the first of which is denominated in U.S. dollars and the second in Euros. Each collateral investment pool is managed by the lending agent, is segregated from all other clients of the lending agent, and is not subject to custodial credit risk. The System's income from securities lending represents its pro-rata share from participating in the program. The weighted-average maturity of the investments in the pool was 2 days at June 30, 2012 and 2011. During the fiscal years ended June 30, 2012 and 2011, the mismatch between the maturities of the investments made with cash collateral and the maturities of the securities loans may have posed some interest rate risk to the System. The System cannot pledge or sell collateral securities received unless the borrower defaults. In the event of a default, the lending agent may use the collateral to replace the loaned securities.

As of June 30, 2012, the fair value of loaned securities was \$2,841,486,000, which includes \$2,343,034,000 of loaned securities which are collateralized by securities and irrevocable letters of credit that are not included in the Statements of Plan Net Assets. The fair value of the associated collateral was \$2,962,708,000 of which \$506,804,000 was cash. As of June 30, 2011, the fair value of loaned securities was \$1,338,387,000, which includes \$600,228,000 of loaned securities which are collateralized by securities and irrevocable letters of credit that are not included in the Statements of Plan Net Assets. The fair value of the associated collateral was \$1,412,915,000 of which \$761,805,000 was cash.

Notes to Financial Statements (continued)**5. Derivative and Other Similar Investments**

The System enters into a variety of financial contracts, which include options and futures. The System also enters into foreign exchange positions, such as forward and spot contracts to obtain or hedge foreign currency exposure; swap agreements to gain exposure to certain sectors of the equity and fixed income markets; collateralized mortgage obligations (CMOs); other forward contracts, and U.S. Treasury strips. The System is not a dealer, but an end-user of these instruments. The contracts are used primarily to enhance performance and reduce the volatility of the portfolio. The System is exposed to credit risk in the event of non-performance by counterparties to financial instruments. The System generally enters into transactions only with high quality institutions. Legal risk is mitigated through selection of executing brokers and review of all documentation. The System is exposed to market risk, the risk that future changes in market conditions may make an instrument less valuable. Exposure to market risk is managed in accordance with risk limits set by senior management, through buying or selling instruments or entering into offsetting positions.

The notional or contractual amounts of derivatives indicate the extent of the System's involvement in the various types and uses of derivative financial instruments and do not measure the System's exposure to credit or market risks and do not necessarily represent amounts exchanged by the parties. The amounts exchanged are determined by reference to the notional amounts and the other terms of the derivatives.

Futures contracts are contracts in which the buyer agrees to purchase and the seller agrees to make delivery of a specific financial instrument at a predetermined date and price. Gains and losses on futures contracts are settled daily based on a notional (underlying) principal value and do not involve an actual transfer of the specific instrument. Futures contracts are standardized and are traded on exchanges. The exchange assumes the risk that a counterparty will not pay and generally requires margin payments to minimize such risk. In addition, the System enters into short sales, sales of securities it does not presently own, to neutralize the market risk of certain equity positions. Initial margin requirements on futures contracts and collateral for short

sales are provided by investment securities pledged as collateral and by cash held by various brokers. Although the System has the right to access individual pledged securities, it must maintain the amount pledged by substituting other securities for those accessed. The value of securities pledged and the amount of cash held at June 30, 2012 and 2011 represent a restriction on the amount of assets available as of year-end for other purposes.

Option contracts provide the option purchaser with the right, but not the obligation, to buy or sell the underlying security at a set price during a period or at a specified date. The option writer is obligated to buy or sell the underlying security if the option purchaser chooses to exercise the option. The System generally uses exchange listed currency, index, stock, and futures options. The fair value of option contracts of \$25,617,000 and \$7,289,000 at June 30, 2012 and 2011, respectively, is included in the Statements of Plan Net Assets.

Foreign exchange contracts involve an agreement to exchange the currency of one country for the currency of another country at an agreed-upon price and settlement date. To reduce the risk of counterparty non-performance, the investment managers generally enter into these contracts with institutions regarded as meeting high standards of credit worthiness. The contracts reported below on the following page primarily include forwards. The \$9,497,409,000 of foreign currency contracts outstanding at June 30, 2012 consist of "buy" contracts, which represent the U.S. dollar equivalents of commitments to purchase foreign currencies of \$4,376,438,000 and "sell" contracts, which represent U.S. dollar equivalents of commitments to sell foreign currencies of \$5,120,971,000. The \$9,941,182,000 of foreign currency contracts outstanding at June 30, 2011 consist of "buy" contracts of \$5,342,849,000 and "sell" contracts of \$4,598,333,000. The unrealized gain (loss) on contracts of \$(7,891,000) and \$3,896,000 at June 30, 2012 and 2011, respectively, is included in the Statements of Plan Net Assets and represents the fair value of the contracts.

FINANCIAL SECTION

Notes to Financial Statements (continued)

The table presented below summarizes the aggregate notional or contractual amounts for the System's derivative financial instruments at June 30, 2012 and 2011.

	(Dollar Amounts in Thousands)	
	2012	2011
Futures contracts - long:		
Treasury futures	\$ 386,242	\$ 295,044
Eurodollar futures	-	551,678
U.S. equity futures	550,224	613,483
Non-U.S. equity futures	217,950	175,136
Commodity futures	1,339,130	1,526,770
Non-U.S. bond futures	-	77,793
Futures contracts - short:		
Treasury futures	209,438	187,080
Eurodollar futures	49,991	275,905
U.S. equity futures	-	99,626
Non-U.S. bond futures	-	56,045
Foreign exchange forward and spot contracts, gross	9,497,409	9,941,182
Options - calls purchased	5,103,649	4,336,538
Options - puts purchased	5,140,968	4,708,379
Options - calls sold	5,751,549	4,673,491
Options - puts sold	5,831,011	5,024,008
Swaps - total return type	2,338,655	2,931,449

The fair values of derivative instruments outstanding at June 30, 2012 and 2011 are classified by type and by the changes in fair value of the derivative instrument in the table below.

Investment Derivative Type	(Dollar Amounts in Thousands)			
	Change in Fair Value Gain/(Loss) FY 2012		Fair Value at June 30, 2012	
	Classification	Amount	Classification	Amount
Futures	Investment income	\$ 11,174	Receivable/(Payable)	\$ 11,174
Total return type swaps	Investment income	(23,260)	Receivable/(Payable)	(23,260)
Options	Investment income	25,617	Investment	25,617
Foreign exchange contracts	Investment income	(7,891)	Receivable/(Payable)	(7,891)
Total		<u>\$ 5,640</u>		<u>\$ 5,640</u>
Investment Derivative Type	(Dollar Amounts in Thousands)			
	Change in Fair Value Gain/(Loss) FY 2011		Fair Value at June 30, 2011	
	Classification	Amount	Classification	Amount
Futures	Investment income	\$ (26,858)	Receivable/(Payable)	\$ (26,858)
Total return type swaps	Investment income	28,794	Receivable/(Payable)	28,794
Options	Investment income	7,289	Investment	7,289
Foreign exchange contracts	Investment income	3,896	Receivable/(Payable)	3,896
Total		<u>\$ 13,121</u>		<u>\$ 13,121</u>

FINANCIAL SECTION

Notes to Financial Statements (continued)

The following table summarizes the System's foreign exchange contracts by currency at June 30, 2012 and 2011:

2012				
(Dollar Amounts in Thousands)				
Currency	Buys	Unrealized Gain/(Loss)	Sells	Unrealized Gain/(Loss)
Euro	\$ 746,352	\$ (4,418)	\$ 1,350,760	\$ (1,985)
Japanese yen	379,984	(807)	354,361	734
Australian dollar	343,044	7,831	346,844	(6,826)
British pound sterling	324,185	2,330	506,845	(1,875)
Mexican new peso	266,694	7,152	193,829	(5,942)
Canadian dollar	237,112	1,409	234,769	(966)
Turkish lira	200,666	2,497	99,968	(1,386)
Brazil real	196,941	2,739	126,023	(2,077)
New Zealand dollar	170,912	4,248	175,612	(5,503)
Norwegian krone	168,289	1,360	89,258	(453)
South African rand	148,768	2,116	76,178	(1,264)
Indonesian rupiah	131,107	(2,192)	128,228	865
Indian rupee	130,890	(252)	104,850	(259)
Swiss franc	119,192	661	424,828	(3,640)
Swedish krona	105,483	2,008	290,916	(8,691)
Hungarian forint	88,252	4,496	8,249	(236)
Taiwan dollar	86,403	(626)	135,764	896
Other non-US currencies	532,164	787	473,689	(622)
Total	\$ 4,376,438	\$ 31,339	\$ 5,120,971	\$ (39,230)

2011				
(Dollar Amounts in Thousands)				
Currency	Buys	Unrealized Gain/(Loss)	Sells	Unrealized Gain/(Loss)
Euro	\$ 811,997	\$ 6,664	\$ 805,874	\$ (6,999)
Brazil real	405,682	11,530	264,077	(5,937)
Swiss franc	373,760	884	390,096	(160)
Australian dollar	345,768	2,981	197,644	(2,932)
British pound sterling	336,006	(4,028)	417,026	4,981
Canadian dollar	309,000	2,677	353,205	(4,410)
Norwegian krone	262,880	2,685	102,507	(1,673)
Japanese yen	255,697	1,879	256,718	(721)
South African rand	247,660	1,378	133,093	(2,618)
Turkish lira	212,215	(4,230)	110,831	1,497
New Zealand dollar	210,700	2,388	201,563	(2,362)
Swedish krona	210,291	559	221,263	(2,402)
Indonesian rupiah	208,656	2,296	54,681	(101)
Hungarian forint	151,655	2,109	92,520	(2,200)
Indian rupee	134,337	1,762	73,340	(583)
Taiwan dollar	98,614	(43)	196,674	(1,463)
Russian ruble	91,420	888	40,380	(205)
Mexican new peso	87,501	710	60,635	(659)
Other non-US currencies	589,010	4,167	626,206	(4,413)
Total	\$ 5,342,849	\$ 37,256	\$ 4,598,333	\$ (33,360)

Notes to Financial Statements (continued)

Swap agreements provide for periodic payments at predetermined future dates between parties based on the change in value of underlying securities, indexes or interest rates. During the year ended June 30, 2012 and 2011, the System entered into total return type swaps. Under the total return type swap arrangements, the System receives the net return of certain equity securities or indexes in exchange for a short-term rate minus a spread or a predetermined fixed charge. The receivable (payable) on the total return type swap contracts of \$(23,260,000) and \$28,794,000 at June 30, 2012 and 2011, respectively, is included in the Statements of Plan Net Assets and represents the fair value of the contracts. The contracts have varying maturity dates ranging from August 14, 2012 to July 1, 2013.

The System also invests in mortgage-backed securities (MBS) such as CMOs and MBS forwards to maximize yields. These securities are sensitive to prepayments of mortgages, which may result from a drop in interest rates. The MBS forwards are subject to credit risk in the event of nonperformance by counterparties. The fair value of CMOs at June 30, 2012 and 2011 is \$1,437,519,000 and \$1,735,359,000, respectively.

The System invests in U.S. Treasury strips which essentially act as zero coupon bonds and are subject to market volatility from a rise or drop in interest rates.

Through certain collective trust funds, the System also indirectly holds various derivative financial instruments. The collective trust funds invest in futures and options thereon; forward foreign currency contracts; options; interest rate, currency, equity, index, and total return swaps; interest-only strips; and CMOs, to enhance the performance and reduce the volatility of their portfolios.

6. Pension Plan for Employees of the System

The System contributes to the Commonwealth's State Employees' Retirement System (SERS), a cost-sharing multiple-employer defined benefit pension plan. SERS provides retirement, death, and disability benefits to plan members and beneficiaries according to Commonwealth statute. SERS issues a publicly available financial report that can be obtained by writing to SERS, 30 N. Third Street, P. O. Box 1147, Harrisburg, Pennsylvania 17108-1147.

The contribution requirements of plan members and the System are mandated by Commonwealth statute. Most SERS plan members are required to contribute 5%, 6.25%, or 9.37% of their annual covered payroll depending upon service class. The System is required to contribute at an actuarially determined rate.

The rates applied to annual covered payroll were 6.99% at June 30, 2012, 4.11% at June 30, 2011, 3.15% at June 30, 2010. The System's contributions to SERS for the years ended June 30, 2012, 2011 and 2010 were \$1,363,000, \$790,000 and \$601,000, respectively, which were equal to the required contributions each year.

7. Postemployment Healthcare Plan for Employees of the System

The System participates in the Commonwealth's Retired Employees Health Program (REHP). The REHP is a single-employer plan and provides certain healthcare benefits to qualifying individuals meeting specified age and/or service requirements. The Commonwealth's Office of Administration (OA), in its sole discretion, determines available REHP benefits on an ongoing basis. The Pennsylvania Employees Benefit Trust Fund (PEBTF) is a third-party administrator for the REHP under the provisions of an Administration Agreement between OA and PEBTF.

Employer costs for retiree healthcare benefits are charged as a component of payroll expenditures on a 'pay-as-you-go' basis. REHP funding is arranged between OA and the Governor's Budget Office. FY 2012 employer costs were charged at the rate of \$240/employee/bi-weekly pay period. Plan members who retired after June 30, 2005 contribute to the plan based on a percentage of their final annual gross base salary at the time of retirement. Plan member contribution rates vary based on their REHP enrollment date.

In September 2011, the Commonwealth released an Actuarial Valuation of its Post-Retirement Medical Plan with calculations made as of July 1, 2011 using census data collected as of December 2010 and health care claims costs for calendar 2010. This valuation provided Other Postemployment Benefits (OPEB) reporting that was used for both FY 2011 and FY 2012. For FY 2011, the valuation indicated overall AOC of \$883.2 million with the System's allocated AOC \$3.2 million. Based on the aggregate REHP qualifying contributions for FY 2011, the net OPEB liability for the System was \$1.1 million for that fiscal year. For FY 2012, the valuation indicated overall AOC of \$870.2 million with the System's allocated AOC \$3.1 million. Based on the aggregate REHP qualifying contributions for FY 2012, the net OPEB liability for the System was \$0.9 million for that fiscal year.

Notes to Financial Statements (continued)

(Dollar Amounts in Thousands)			
Fiscal Year	Commonwealth ARC/AOC	PSERS' ARC/AOC	PSERS' Net OPEB
2012	\$ 870,200	\$ 3,132	\$ 871
2011	883,160	3,179	1,070
2010	850,440	3,705	1,460

8. Litigation and Contingencies

The System is subject to various threatened and pending lawsuits. These lawsuits include issues related to benefit calculations and eligibility. It is the opinion of management that the ultimate liability arising from such threatened and pending litigation will not have a material effect on the financial position of the System. The System is exposed to various other liabilities and risks related to fiduciary responsibilities of directors and officers.



9. Commitments

As of June 30, 2012, PSERS had commitments for the future purchase of investments in alternative investments of \$4.9 billion and real estate of \$2.3 billion.

10. Subsequent Events

The System has performed an evaluation of subsequent events through September 18, 2012, the date the basic financial statements were available to be issued. No material events were identified by the System.

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FINANCIAL SECTION

Required Supplementary Schedule 1 Schedules of Funding Progress* (Unaudited – See Accompanying Auditor’s Report) (Dollar Amounts in Millions)

Pension							
(1)	(2)	(3)	(4)	(5)	(6)		
Valuation as of June 30	Actuarial liabilities (AAL)	Actuarial value of assets	Unfunded actuarial liabilities UAAL (1) - (2)	Ratio of assets to AAL (2) / (1)	Covered payroll	UAAL as a percentage of covered payroll (3) / (5)	
2011	\$ 85,640.4	\$ 59,141.1	\$ 26,499.3	69.1%	\$ 12,910.0	205.3%	
2010	79,005.4	59,306.8	19,698.6	75.1%	12,788.8	154.0%	
2009	75,520.7	59,781.6	15,739.1	79.2%	12,524.6	125.7%	
2008	70,845.6	60,922.1	9,923.5	86.0%	11,921.5	83.2%	
2007	66,495.8	57,057.8	9,438.0	85.8%	11,410.3	82.7%	
2006	64,627.3	52,464.7	12,162.6	81.2%	11,419.0	106.5%	

Premium Assistance							
(1)	(2)	(3)	(4)	(5)	(6)		
Valuation as of June 30	Actuarial liabilities (AAL)	Actuarial value of assets	Unfunded actuarial liabilities UAAL (1) - (2)	Ratio of assets to AAL (2) / (1)	Covered payroll	UAAL as a percentage of covered payroll (3) / (5)	
2011	\$ 1,339.4	\$ 111.3	\$ 1,228.2	8.3%	\$ 12,910.0	9.5%	
2010	1,162.2	116.8	1,045.4	10.1%	12,788.8	8.2%	
2009	1,159.0	105.1	1,053.9	9.1%	12,524.6	8.4%	

* The amounts reported above in the Schedule of Funding Progress do not include assets or liabilities for the HOP.

Each time a new benefit is added which applies to service already rendered, an “unfunded accrued liability” is created. The laws governing PSERS require that these additional liabilities be financed systematically over a period of future years. Also, if actual financial experiences are less favorable than assumed financial experiences, the difference is added to unfunded accrued liabilities.

In an inflationary economy, the value of the dollar is decreasing. In this environment, employees pay in greater dollar amounts, resulting in a dollar increase in unfunded

accrued liabilities. This occurs at a time when the actual substance of these items may be decreasing. Looking at just the dollar amounts of unfunded accrued liabilities can be misleading. Unfunded accrued liabilities divided by active employee payroll provides an index which clarifies understanding. The smaller the ratio of unfunded liabilities to covered payroll, the stronger the system. Observation of this relative index over a period of years will give an indication of whether the system is becoming financially stronger or weaker.

FINANCIAL SECTION

Required Supplementary Schedule 2 Schedules of Employer Contributions (Unaudited – See Accompanying Auditor’s Report) (Dollar Amounts in Thousands)

Pension				
Year ended June 30	Annual Required Contributions	Actual Employer Contributions*	Percentage Contributed	
2012	\$ 2,629,244	\$ 1,001,140	38%	
2011	2,436,602	646,560	27%	
2010	1,928,278	527,212	27%	
2009	1,761,295	503,227	29%	
2008	1,852,238	753,532	41%	
2007	1,708,821	659,545	39%	

Premium Assistance				
Year ended June 30	Annual Required Contributions	Actual Employer Contributions	Percentage Contributed	
2012	\$ 102,104	\$ 80,936	79%	
2011	119,320	88,796	74%	
2010	117,187	102,703	88%	

The Board adopted all contribution rates as recommended by the Board’s actuary pursuant to the prevailing provisions of the Retirement Code for each year, with the exception of the year ended June 30, 2011. Act 46 required the Board to recertify the employer contribution rate from 8.22% to 5.64%, allocating 5% to the pension component and .64% to the premium assistance component.

* Includes purchase of service contributions in FY 2007 and FY 2008.

FINANCIAL SECTION

Supplementary Schedule 1 Schedule of Operating Expenses Year Ended June 30, 2012 (Dollar Amounts in Thousands)

	Administrative Expenses (1)	Investment Expenses (2)	Total
Personnel costs:			
Salaries and wages	\$ 15,268	\$ 3,681	\$ 18,949
Social security contributions	1,144	229	1,373
Retirement contributions	1,104	259	1,363
Employees' insurance contributions	4,713	545	5,258
Other employee benefits	50	130	180
Total personnel costs	22,279	4,844	27,123
Operating costs:			
Investment managers' fees	-	467,195	467,195
Custodian fees	-	604	604
Specialized services	17,553	2,856	20,409
Rental of real estate, electricity	2,028	179	2,207
Consultant and legal fees	2,941	3,447	6,388
Treasury and other commonwealth services	1,509	182	1,691
Postage	989	-	989
Contracted maintenance and repair services	963	14	977
Office supplies	247	14	261
Rental of equipment and software	1,619	187	1,806
Printing	304	-	304
Travel and training	165	13	178
Telecommunications	730	1	731
Equipment (non-capital assets)	2,565	4	2,569
Miscellaneous expenses	792	1,746	2,538
Total operating costs	32,405	476,442	508,847
Other charges:			
Depreciation	1,836	-	1,836
Total other charges	1,836	-	1,836
Total operating expenses	\$ 56,520	\$ 481,286	\$ 537,806

(1) Includes administrative expenses of \$2,065 related to Postemployment Healthcare Premium Assistance and \$20,213 related to Postemployment Healthcare Health Options Program for the fiscal year ended June 30, 2012.

(2) Includes investment expenses of \$52 related to Postemployment Healthcare Premium Assistance for fiscal year ended June 30, 2012 and does not include \$8,006 in capitalized broker commissions for the fiscal year ended June 30, 2012.

FINANCIAL SECTION**Supplementary Schedule 2
Summary of Investment Expenses
Year Ended June 30, 2012
(Dollar Amounts in Thousands)**

	<u>Fees</u>
External management:	
Domestic equity	\$ 2,869
International equity	22,225
Fixed income	64,644
Real estate	74,758
Alternative investments	140,914
Absolute return	138,992
Commodities	19,517
Master limited partnership	810
Risk parity	2,466
Total external management	467,195
Total internal management	10,040
Total investment management	477,235
Custodian fees	604
Consultant and legal fees	3,447
Total investment expenses	\$ 481,286

FINANCIAL SECTION

Supplementary Schedule 3
Schedule of Payments to Non-Investment Consultants
Year Ended June 30, 2012
(Dollar Amounts Greater than \$50,000)

Consultant	Fees	Services Provided
CoreSource Inc.	\$ 13,046,823	Postemployment healthcare benefits administration and claims adjudication
ViTech Systems Group Inc.	5,422,005	Pension administration system services
Rx Solutions, Inc	4,109,161	Administration of postemployment healthcare benefits and prescription drug plan
The Segal Company, Inc.	2,631,905	Actuarial services and consulting for HOP and prescription drug plan
Independent Pharmaceutical Consultants, Inc.	527,691	Pharmacy benefit consulting services
Buck Consultants LLC	389,471	Pension benefit actuarial services
CliftonLarsonAllen LLP	115,000	Financial audit of pension system and postemployment healthcare programs