Public School Employees' Retirement System

Financial Section

Clifton Gunderson LLP
Certified Public Accountants & Consultants
COUNT ON INSIGHT℠

Independent Auditor's Report

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

We have audited the accompanying basic 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, 2005 and 2004, as listed in the table of contents. These financial statements are the responsibility of the 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, 2005 and 2004, 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.

The Management's Discussion and Analysis and Required Supplemental Schedules of Funding Progress and Employer Contributions (Schedules 1 and 2) are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

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

Clifton Gunderson LLP

Baltimore, Maryland
September 23, 2005

Management's Discussion and Analysis

Management's Discussion and Analysis (MD&A) of the Commonwealth of Pennsylvania Public School Employees' Retirement System's (PSERS) for the fiscal year ended June 30, 2005, provides a narrative summary of the financial position and performance, including highlights and comparative data. The MD&A is presented as required supplemental information to the financial statements and should be read in conjunction with the letter of transmittal, 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 (Premium Assistance) and the Health Options Program (HOP), for its annuitants. The financial statements present the financial 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, 2005, 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, 2004 to June 30, 2005, 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.

The *Required Supplemental Schedules* immediately following the notes to financial statements provide two schedules showing historical information concerning the funded status of PSERS and the employer contributions.

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

Financial Highlights

- PSERS' total plan net assets increased by $3.6 billion from $48.5 billion at June 30, 2004 to $52.1 billion at June 30, 2005. The increase is primarily attributable to net investment income and member and employer contributions combined that exceeded the payment of pension benefits and administrative expenses.

Management's Discussion and Analysis (Continued)

- The pension plan's funded ratio as of the latest actuarial valuation dated June 30, 2004 decreased from 97.2% to 91.2%. The decrease is primarily due to the residual effect of an actuarial asset loss caused by the downturn in the financial markets from 2000 to 2002.
- The rate of return on investments was 12.87% for the fiscal year ended June 30, 2005 and 19.67% for the fiscal year ended June 30, 2004.
- Total member contributions increased slightly from $944 million in FY 2004 to $955 million in FY 2005. Total employer contributions increased from $407 million in FY 2004 to $458 million in FY 2005. The net increase is primarily attributable to an increase in the pension contribution rate from 2.98% in FY 2004 to 4.00% in FY 2005 partially offset by a reduction in the health insurance premium assistance contribution rate from 0.79% in FY 2004 to 0.23% in FY 2005.
- Total PSERS' benefit payouts increased by 10.9% from $3.5 billion in FY 2004 to $3.9 billion in FY 2005. The increase is primarily attributable to an increase in the number of retirees and beneficiaries currently receiving benefits.
- Total administrative expenses decreased by 13.3% from $49.2 million in FY 2004 to $42.6 million in FY 2005 primarily due to the planned reduction of expenditures for the third year of the New Pension Administration System (NPAS) project. Administrative expenses were within PSERS' budgeted amounts for both years.

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 is 91.2% funded as of June 30, 2004. The results of operations for FY 2005 will be reflected in the actuarial valuation for the year ended June 30, 2005. Due to the normal lag time for completion of the actuarial valuation, the resulting funded status will be available at the end of the calendar year and will be reported in the financial statements for the fiscal year ended June 30, 2006

Management's Discussion and Analysis (Continued)

Analysis of Plan Net Assets

(Dollar Amounts in Thousands)

Summary of Plan Net Assets:	FY 2005	Increase (Decrease)	FY 2004	Increase (Decrease)	FY 2003
Assets:					
Receivables	**$ 1,521,994**	$ 436,885	$ 1,085,109	$ (197,324)	$ 1,282,433
Investments	**52,938,052**	3,906,373	49,031,679	5,311,675	43,720,004
Securities lending collateral pool	**6,600,684**	2,095,256	4,505,428	1,117,738	3,387,690
Fixed assets	**873**	(641)	1,514	(914)	2,428
Total Assets	**61,061,603**	6,437,873	54,623,730	6,231,175	48,392,555
Liabilities:					
Payables and other liabilities	**2,349,493**	768,290	1,581,203	(935,744)	2,516,947
Obligations under securities lending	**6,600,684**	2,095,256	4,505,428	1,117,738	3,387,690
Total Liabilities	**8,950,177**	2,863,546	6,086,631	181,994	5,904,637
Plan Net Assets	**$ 52,111,426**	$ 3,574,327	$ 48,537,099	$ 6,049,181	$ 42,487,918

Summary of Changes in Plan Net Assets:	FY 2005	Increase (Decrease)	FY 2004	Increase (Decrease)	FY 2003
Additions:					
Contributions	**$ 1,413,317**	$ 62,173	$ 1,351,144	$ 337,381	$ 1,013,763
Net investment income	**6,081,497**	(2,163,107)	8,244,604	7,222,137	1,022,467
Total Additions	**7,494,814**	(2,100,934)	9,595,748	7,559,518	2,036,230
Deductions:					
Benefit payments	**3,877,842**	380,477	3,497,365	394,681	3,102,684
Administrative expenses	**42,645**	(6,557)	49,202	6,924	42,278
Total Deductions	**3,920,487**	373,920	3,546,567	401,605	3,144,962
Changes in Plan Net Assets	**$ 3,574,327**	$ (2,474,854)	$ 6,049,181	$ 7,157,913	$ (1,108,732)

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 that diversification among various asset classes 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.

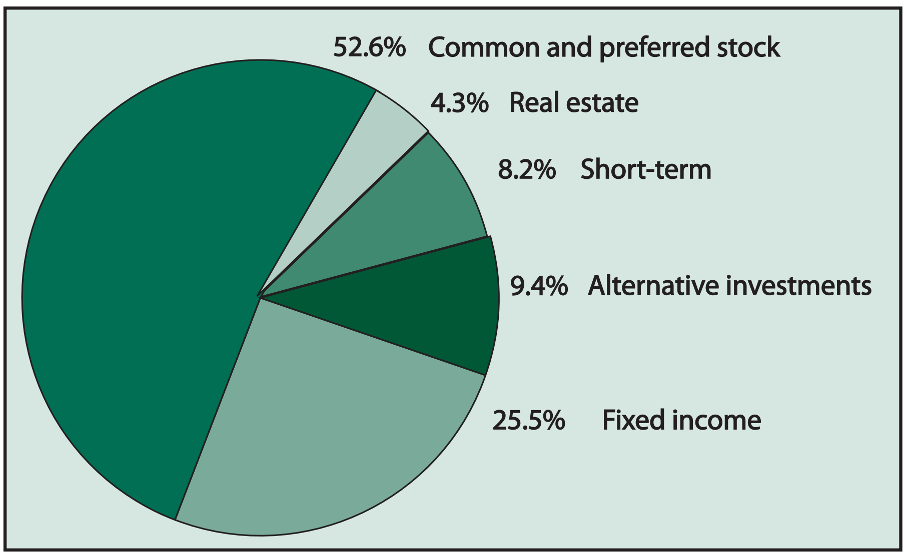
Management's Discussion and Analysis (Continued)

For FY 2005, PSERS' rate of return on investments was 12.87%. The FY 2005 investment return exceeded PSERS' total fund policy benchmark of 10.54% and placed PSERS' performance in the top quartile of the Public Fund Universe prepared by the System's investment evaluator, Wilshire Associates Inc. (Wilshire). The annualized rate of return over the past three and five-year periods ended June 30, 2005 was 11.54% and 4.02%, respectively. The annualized rate of return for the ten-year period ended June 30, 2005 was 9.69% on a gross of fees basis. PSERS' long-term actuarial investment return assumption is 8.50%.

The asset distribution of PSERS' investment portfolio at June 30, 2005 and June 30, 2004 at fair value, including postemployment healthcare assets, was:

	(Dollar Amounts in Thousands)			
Asset Class	**2005**	**%**	2004	%
Short-term	**$ 4,337,012**	**8.2**	$ 3,328,633	6.8
Fixed income	**13,470,565**	**25.5**	12,120,327	24.7
Common and preferred stock	**27,859,789**	**52.6**	26,688,099	54.4
Real estate	**2,285,617**	**4.3**	2,209,767	4.5
Alternative investments	**4,985,069**	**9.4**	4,684,853	9.6
Total	**$ 52,938,052**	**100.0**	$ 49,031,679	100.0

Asset Distribution
Fiscal Year Ended June 30, 2005



Management's Discussion and Analysis (Continued)

Short-term investments at the close of FY 2005 increased by $1.0 billion from $3.3 billion in FY 2004 to $4.3 billion in FY 2005 due primarily to an increase in the short-term investments required to support futures contracts for a new investment manager. Fixed income investments increased by $1.4 billion from $12.1 billion in FY 2004 to $13.5 billion in FY 2005 primarily as a result of positive returns in domestic and international fixed income markets. Common and preferred stock investments increased by $1.2 billion from $26.7 billion in FY 2004 to $27.9 billion in FY 2005. The increase was primarily due to positive returns in the domestic and international equity markets that were partially offset by reductions to the asset class during FY 2005 in accordance with PSERS' asset allocation plan. Real estate investments increased by $75.8 million from $2.2 billion in FY 2004 to $2.3 billion in FY 2005. Alternative investments increased by $300 million from $4.7 billion in FY 2004 to $5.0 billion in FY 2005 due to the addition of new investment partnerships, drawdowns of commitments to existing partnerships and market value appreciation. Real estate and alternative investments remained relatively consistent on a percentage basis over FY 2005.

Contributions and Investment Income

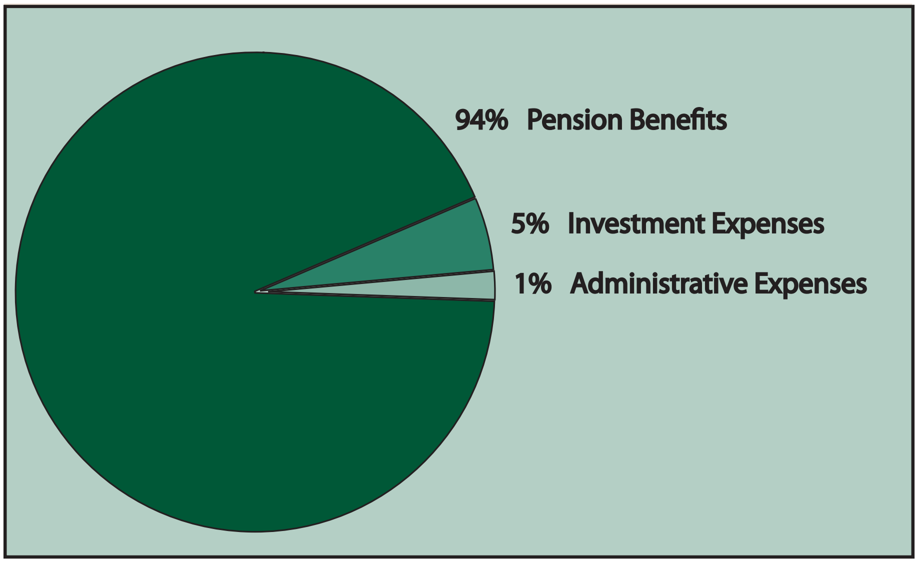
Employer pension contributions increased by $110.4 million from $321.1 million in FY 2004 to $431.5 million in FY 2005. The increase was attributable to the increase in the employer pension contribution rate from 2.98% in FY 2004 to 4.00% in FY 2005. Member pension contributions increased by $4.6 million from $783.7 million in FY 2004 to $788.3 million in FY 2005 as a result of the increase in the total participant salary base. The contributions for health insurance premium assistance decreased by $59.3 million from $85.6 million in FY 2004 to $26.3 million in FY 2005 due to the reduction in the health insurance premium assistance contribution rate from 0.79% in FY 2004 to 0.23% in FY 2005. Net investment income decreased by $2.1 billion from $8.2 billion in FY 2004 to $6.1 billion in FY 2005, which correlates to the decrease in the investment rate of return from 19.67% for FY 2004 to 12.87% for FY 2005. Although net investment income decreased from FY 2004 to FY 2005, the Fund's investment performance in FY 2005 was strong and its investment returns placed it in the top quartile of Wilshire's Public Fund Universe. 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.

Management's Discussion and Analysis (Continued)

Total PSERS' Benefits and Expenses

The primary source of expense during FY 2005 was for the payment of benefits totaling $3.9 billion. This compares to benefit payments of $3.5 billion during FY 2004. Investment expenses remained consistent and only increased by $1.4 million from $191.3 million during FY 2004 to $192.7 million during FY 2005. Investment expenses are reported as a reduction in net investment income on the Statement of Changes in Plan Net Assets. Administrative expenses decreased by $6.6 million from $49.2 million during FY 2004 compared to $42.6 million during FY 2005. The decrease was primarily due to the planned third-year expenditure reductions for the NPAS project.

Total PSERS' Benefits and Expenses
Fiscal Year Ended June 30, 2005



Statements of Plan Net Assets

June 30, 2005 and 2004

(Dollar Amounts in Thousands)

	2005			
		Postemployment Healthcare		
	Pension	Premium Assistance	Health Options Program	Totals
Assets:				
Receivables:				
Members	**$ 214,857**	**$ 1,127**	**$ 38**	**$ 216,022**
Employers	**140,971**	**6,939**	**-**	**147,910**
Investment income	**176,712**	**678**	**168**	**177,558**
Investment proceeds	**974,114**	**-**	**-**	**974,114**
Miscellaneous	**6,100**	**281**	**9**	**6,390**
Total Receivables	**1,512,754**	**9,025**	**215**	**1,521,994**
Investments, at fair value:				
Short-term	**4,154,565**	**91,769**	**90,678**	**4,337,012**
Fixed income	**13,454,688**	**-**	**15,877**	**13,470,565**
Common and preferred stock	**27,859,789**	**-**	**-**	**27,859,789**
Real estate	**2,285,617**	**-**	**-**	**2,285,617**
Alternative investments	**4,985,069**	**-**	**-**	**4,985,069**
Total Investments	**52,739,728**	**91,769**	**106,555**	**52,938,052**
Securities lending collateral pool	**6,600,684**	**-**	**-**	**6,600,684**
Capital assets (net of accumulated depreciation of $10,084)	**873**	**-**	**-**	**873**
Total Assets	**60,854,039**	**100,794**	**106,770**	**61,061,603**
Liabilities:				
Accounts payable and accrued expenses	**41,262**	**299**	**2,000**	**43,561**
Benefits payable	**214,634**	**57**	**12,756**	**227,447**
Participant premium advances	**-**	**-**	**14,122**	**14,122**
Investment purchases and other liabilities	**2,061,062**	**3,301**	**-**	**2,064,363**
Obligations under securities lending	**6,600,684**	**-**	**-**	**6,600,684**
Total Liabilities	**8,917,642**	**3,657**	**28,878**	**8,950,177**
Net assets held in trust for pension and postemployment healthcare benefits (A schedule of funding progress is presented on Required Supplemental Schedule 1)	**$51,936,397**	**$ 97,137**	**$ 77,892**	**$52,111,426**

These financial statements should be read only in connection with the accompanying notes to financial statements.

Statements of Plan Net Assets

June 30, 2005 and 2004

(Dollar Amounts in Thousands)

	2004			
		Postemployment Healthcare		
	Pension	Premium Assistance	Health Options Program	Totals
Assets:				
Receivables:				
Members	$ 214,599	$ 834	$ 20	$ 215,453
Employers	102,982	25,484	-	128,466
Investment income	169,050	621	163	169,834
Investment proceeds	568,987	-	-	568,987
Miscellaneous	2,157	203	9	2,369
Total Receivables	1,057,775	27,142	192	1,085,109
Investments, at fair value:				
Short-term	3,138,767	118,107	71,759	3,328,633
Fixed income	12,105,157	-	15,170	12,120,327
Common and preferred stock	26,688,099	-	-	26,688,099
Real estate	2,209,767	-	-	2,209,767
Alternative investments	4,684,853	-	-	4,684,853
Total Investments	48,826,643	118,107	86,929	49,031,679
Securities lending collateral pool	4,505,428	-	-	4,505,428
Capital assets (net of accumulated depreciation of $9,687)	1,514	-	-	1,514
Total Assets	54,391,360	145,249	87,121	54,623,730
Liabilities:				
Accounts payable and accrued expenses	33,192	281	8,212	41,685
Benefits payable	168,013	64	12,881	180,958
Participant premium advances	-	-	13,435	13,435
Investment purchases and other liabilities	1,345,078	47	-	1,345,125
Obligations under securities lending	4,505,428	-	-	4,505,428
Total Liabilities	6,051,711	392	34,528	6,086,631
Net assets held in trust for pension and postemployment healthcare benefits (A schedule of funding progress is presented on Required Supplemental Schedule 1)	$48,339,649	$ 144,857	$ 52,593	$48,537,099

These financial statements should be read only in connection with the accompanying notes to financial statements.

Statements of Changes in Plan Net Assets

Years ended June 30, 2005 and 2004

(Dollar Amounts in Thousands)

	2005			
		Postemployment Healthcare		
	Pension	Premium Assistance	Health Options Program	Totals
Additions:				
Contributions:				
Members	$ 788,310	$ -	$ 167,199	$ 955,509
Employers	431,556	26,252	-	457,808
Total contributions	1,219,866	26,252	167,199	1,413,317
Investment income:				
From investing activities:				
Net appreciation (depreciation) in fair value of investments	4,463,930	(2,218)	672	4,462,384
Short-term	65,772	4,635	1,389	71,796
Fixed income	594,224	-	585	594,809
Common and preferred stock	676,549	-	-	676,549
Real estate	187,178	-	-	187,178
Alternative investments	265,355	-	-	265,355
Total investment activity income	6,253,008	2,417	2,646	6,258,071
Investment expenses	(192,629)	(48)	-	(192,677)
Net income from investing activities	6,060,379	2,369	2,646	6,065,394
From securities lending activities:				
Securities lending income	125,882	-	-	125,882
Securities lending expense	(109,779)	-	-	(109,779)
Net income from securities lending activities	16,103	-	-	16,103
Total net investment income	6,076,482	2,369	2,646	6,081,497
Total Additions	7,296,348	28,621	169,845	7,494,814
Deductions:				
Benefits	3,639,838	74,465	136,447	3,850,750
Refunds of contributions	16,233	-	-	16,233
Net transfer to State Employees' Retirement System	10,859	-	-	10,859
Administrative expenses	32,670	1,876	8,099	42,645
Total Deductions	3,699,600	76,341	144,546	3,920,487
Net increase (decrease)	3,596,748	(47,720)	25,299	3,574,327
Net assets held in trust for pension and postemployment healthcare benefits:				
Balance, beginning of year	48,339,649	144,857	52,593	48,537,099
Balance, end of year	$ 51,936,397	$ 97,137	$ 77,892	$ 52,111,426

These financial statements should be read only in connection with the accompanying notes to financial statements.

Statements of Changes in Plan Net Assets

Years ended June 30, 2005 and 2004

(Dollar Amounts in Thousands)

	2004			
		Postemployment Healthcare		
	Pension	Premium Assistance	Health Options Program	Totals
Additions:				
Contributions:				
Members	$ 783,691	$ -	$ 160,731	$ 944,422
Employers	321,091	85,631	-	406,722
Total contributions	1,104,782	85,631	160,731	1,351,144
Investment income:				
From investing activities:				
Net appreciation (depreciation) in fair value of investments	6,874,420	(3,003)	-	6,871,417
Short-term	29,616	4,627	379	34,622
Fixed income	619,346	-	626	619,972
Common and preferred stock	556,984	-	-	556,984
Real estate	205,229	-	-	205,229
Alternative investments	132,984	-	-	132,984
Total investment activity income	8,418,579	1,624	1,005	8,421,208
Investment expenses	(191,267)	(33)	-	(191,300)
Net income from investing activities	8,227,312	1,591	1,005	8,229,908
From securities lending activities:				
Securities lending income	46,075	-	-	46,075
Securities lending expense	(31,379)	-	-	(31,379)
Net income from securities lending activities	14,696	-	-	14,696
Total net investment income	8,242,008	1,591	1,005	8,244,604
Total Additions	9,346,790	87,222	161,736	9,595,748
Deductions:				
Benefits	3,252,424	71,098	142,761	3,466,283
Refunds of contributions	14,767	-	-	14,767
Net transfer to State Employees' Retirement System	16,315	-	-	16,315
Administrative expenses	40,014	1,714	7,474	49,202
Total Deductions	3,323,520	72,812	150,235	3,546,567
Net increase	6,023,270	14,410	11,501	6,049,181
Net assets held in trust for pension and postemployment healthcare benefits:				
Balance, beginning of year	42,316,379	130,447	41,092	42,487,918
Balance, end of year	$ 48,339,649	$ 144,857	$ 52,593	$ 48,537,099

These financial statements should be read only in connection with the accompanying notes to financial statements.

Notes To Financial Statements

June 30, 2005 and 2004

(1)
Organization and Description of the Public School Employees' Retirement 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 members. Membership in the System is mandatory for nearly all qualifying public school employees in the Commonwealth of Pennsylvania (Commonwealth). In certain instances, qualifying employees of charter schools may retain membership in other retirement plans. At June 30, 2005, there were 734 participating employers, generally school districts. Membership as of June 30, 2004, the most recent year for which actual amounts are available, consisted of:

Currently employed members:		
Vested	168,000	
Nonvested	80,000	
Total currently employed members		**248,000**
Retirees and beneficiaries currently receiving benefits	152,000	
Inactive members and vestees entitled to but not receiving benefits	70,000	
Total retirees and other members		**222,000**
Total number of members		**470,000**

All members are fully vested in their individual balance in the Members' Savings Account which is described in Note 3.

The System is established by state law as an independent administrative board of the Commonwealth, which is directed by the Public School Employees' Retirement Board (the Board) that exercises control and management of the System, including the investment of its assets. The System's 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 non-certified 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 rates by employers and employees are specified in state law. Changes in benefit and contribution provisions for each 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 providing an estimate of the cost and actuarial effect of the proposed change.

Notes to Financial Statements (Continued)

Based upon the 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 Benefits

Under the provisions of the 1975 revision of the Pennsylvania Public School Employees' Retirement Code (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.

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. In most cases after completion of five years of service, a member's right to the defined benefit is vested and early retirement benefits may be elected. Under certain features of the System, active members may purchase credit for various types of prior school and non-school service on a lump-sum, installment purchase basis, or through an actuarially calculated benefit reduction.

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. Such benefits are actuarially equivalent to the benefit that would have been effective if the member had retired on the day before death.

Members with credited service in the Commonwealth of Pennsylvania State Employees' Retirement System (SERS) may elect to transfer service to 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 to SERS upon becoming a member of that system.

Upon termination of a member's employment in the public school sector, the member's accumulated contributions plus interest are refundable from the Members' Savings Account which is described in Note 3.

(c) Postemployment Healthcare Benefits

The System provides a health insurance premium assistance program (premium assistance) for all eligible annuitants who elect to participate. Under this program, employer contribution rates for premium assistance are established to provide reserves in the Health Insurance Account that are sufficient for the payment of premium assistance benefits. 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 employer or the PSERS' Health Options Program (HOP).

Notes to Financial Statements (Continued)

The HOP is a PSERS-sponsored voluntary health insurance program for the sole benefit of PSERS retirees, survivor annuitants, and the spouse, surviving spouse and dependents of retirees or survivor annuitants. Benefits are provided by insurance carriers, health maintenance organizations or by third-party administrators. All retirees are eligible to participate in the High or Standard Options (indemnity plans) regardless of their residence. The HMO, POS and PPO options (managed care plans) are available to retirees residing in the plan's service area. The HOP is funded exclusively by the premiums paid by its participants for the benefit coverage they elect. The hospital, medical/surgical and major medical benefits of the High and Standard Options are self-funded with aggregate stop-loss insurance. PSERS uses a third-party administrator to process these claims. An independent actuarial consulting firm sets the rates for the self-funded benefits so that the combination of contributions and the claims fluctuation reserve equal 125% of expected annual incurred claims. Aggregate stop-loss insurance is purchased to pay claims in excess of 125% of expected annual incurred claims up to the limit of the policy. The HOP maintains a reserve for claims that are incurred but not reported (IBNR). At June 30, 2005, PSERS recorded $10,300,000 in IBNR which is included in benefits payable. The prescription drug benefits of the High Option became self-funded during the fiscal year ended June 30, 2004. The PSERS pension fund assets are not available to fund or satisfy obligations of the HOP.

(d) 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, 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.

Contribution rates for active members are set by law (redefined with the provisions of Act 9 of 2001) and are dependent upon members' class. In most cases, the contribution rates based on qualified member compensation are as follows:

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%

Active members newly hired after July 1, 2001, the effective date of Act 9 of 2001, are automatically Class T-D. The contribution rates for all members in Membership Class T-D were effective January 1, 2002.

Notes to Financial Statements (Continued)

The total contribution rate for the employers and the Commonwealth was 4.23% and 3.77% of qualified compensation for the years ended June 30, 2005 and 2004, respectively. 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. 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 program. The premium assistance contribution rate is set at a level necessary to establish reserves sufficient to provide premium assistance 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 premium assistance was 0.23% and 0.79% for the years ended June 30, 2005 and 2004, respectively.

(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 a published market price or quotation from national security exchanges and 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 security exchanges or securities pricing services. Securities which are not traded on a national security exchange are valued by the respective fund manager or other third parties based on similar sales.

Notes to Financial Statements (Continued)

Real estate owned investments are primarily valued based on appraisals performed by independent appraisers or, for properties not appraised, at cost or the present value of the projected future net income stream. Real estate owned investments are reported net of related debt borrowed against the market value of the property. As of June 30, 2005 and 2004, $132,000,000 in line of credit advances were netted against the related property valuation. The line of credit balance is due on March 17, 2006. The line is payable at an interest rate equivalent to the lender's commercial paper rate plus 30 basis points and is collateralized by certain fixed income investments of the System.

Effective April 30, 2004, the System entered into a contract to purchase a 25% share in one of its venture capital investments from another limited partner. The complete purchase price of $15,364,000 was not payable until December 15, 2004 and included no interest charges. On that same date, the System sold a 5% share in the investment to a third limited partner for $3,073,000. The payment terms, negotiated by the System with the other party, are common in the secondary alternative investment market and allowed the System to obtain the benefits of any increases in the valuations of the partnership's portfolio holdings from the effective date of the contract until the payment date at no additional cost. As of June 30, 2004, the net payable of $12,291,000 was netted against the market value of the related investment for purposes of financial reporting.

Private equity, private debt, venture capital and equity real estate investments are primarily valued based on amounts established by valuation committees. The values for private equity, private debt, venture capital and equity real estate investments are reported on a one-quarter lag (March 31) adjusted for cash flows and significant unrealized losses through June 30. Futures contracts, foreign exchange contracts, and options are marked-to-market daily with changes in market value 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 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 the Securities and Exchange Commission has regulatory oversight.

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, consisting primarily of data processing equipment and software, are recorded at historical cost. The System depreciates capital assets using the straight-line method over an estimated useful life of seven years.

Notes to Financial Statements (Continued)

(d) Benefits Payable

Benefits payable identifies the obligations of the System, on an accrual basis, for the estimated retirement and death benefits payable to PSERS' members or members' beneficiaries at the end of the fiscal year. It also includes the HOP $10,300,000 IBNR claims reserve and a $2,414,000 prescription drug benefit payable at June 30, 2005.

(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, 2005 and 2004, $2,727,000 and $3,032,000, 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

Participant premium advances are for HOP premiums paid in advance in 2005 and 2004 related to health care coverage to be provided in 2006 and 2005, 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.

Federal tax legislation was enacted in 2001 that modified the rules for making rollovers to or from pension systems and also established maximum amounts of retirement benefits that can be paid from pension systems. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) expanded the opportunity for members to roll over funds received from PSERS at retirement to a wider variety of plans including, but not limited to, 403(b) tax sheltered annuities and government sponsored 457 deferred compensation plans. The Act permits the rollover of after-tax contributions from PSERS. EGTRRA provided for periodic increases in the annual compensation limits for qualified retirement plans. The annual compensation limits for 2004 and 2005 were $205,000 and $210,000, respectively. EGTRRA also provided for periodic increases in the annual benefit limits for qualified defined benefit plans. The maximum annual defined benefit limits at age 62 for 2004 and 2005 were $165,000 and $170,000, respectively.

Notes to Financial Statements (Continued)

(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 2004 balances have been reclassified to conform with the 2005 presentation.

(j) Members Receivables

Member's receivables include an amount for members' obligations to the System for the purchase of service credit in the amount of $150,300,000. 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 quarterly 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.

Because members have control over the timing of their remittances to the System, many purchases of service receivables extend beyond one year. An estimated $126,485,000 of the $214,857,000 members pension receivables at June 30, 2005 are expected to be collected by the System subsequent to June 30, 2006.

(k) Adoption of New Accounting Standard

During the year ended June 30, 2005 the System adopted Governmental Accounting Standards Board Statement No. 40, *Deposit and Investment Risk Disclosures (an amendment of GASB Statement No. 3*) ("GASB 40"). The adoption of GASB 40 required the System to include a presentation of Deposit and Investment Risk Disclosures in the Notes to Financial Statements. The adoption of GASB 40 did not have an impact on the System's financial statements.

Notes to Financial Statements (Continued)

(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:

(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 Reserve for Retirement Account increasing the reserve credit to the 8.5% 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 Reserve for Retirement Account for subsequent payment of benefits.

(c) Reserve for Retirement Account

The Reserve for Retirement 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 Reserve for Retirement Account.

(d) Health Insurance Account

The Health Insurance Account is credited with contributions of the Commonwealth and the employers for the health insurance premium assistance 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. 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.

Notes to Financial Statements (Continued)

(f) Pension and Postemployment Healthcare Net Assets

Net assets held in trust for pension and postemployment healthcare benefits at June 30 follows:

	(Dollar Amounts in Thousands)	
	2005	2004
Pension:		
State accumulation account	**$ 14,557,519**	$ 14,371,977
Members' savings account	**9,116,347**	8,755,109
Reserve for retirement account	**28,262,531**	25,212,563
	$ 51,936,397	$ 48,339,649
Postemployment healthcare:		
Health insurance account	**$ 97,137**	$ 144,857
Health insurance program account	**77,892**	52,593
	$ 175,029	$ 197,450

(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 person" standard which allows the Board to consider the probable safety of investments, avoid speculative investments, and invest as people of prudence, discretion, and intelligence would manage their own affairs. 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.

A summary of the fair value of investments at June 30 follows:

Notes to Financial Statements (Continued)

	(Dollar Amounts in Thousands) 2005	2004
Pension investments:		
Short-term:		
Pennsylvania Treasury Domestic Short-Term Investment Fund	**$ 1,949,355**	$ 2,608,896
Other domestic short-term	**901,088**	406,662
Collective trust funds	**1,070,616**	-
International short-term	**233,506**	123,209
	4,154,565	3,138,767
Fixed income:		
Domestic mortgage-backed securities	**4,898,249**	4,856,812
U.S. government and agency obligations	**2,943,165**	2,176,793
Domestic corporate and taxable municipal bonds	**3,178,674**	2,880,925
Miscellaneous domestic fixed income	**198,656**	407,476
Collective trust funds	**276,234**	303,563
International fixed income	**1,959,710**	1,479,588
	13,454,688	12,105,157
Common and preferred stock:		
Domestic common and preferred stock	**17,249,029**	18,143,777
Collective trust funds	**607,223**	335,911
International common stock	**10,003,537**	8,208,411
	27,859,789	26,688,099
Real estate:		
Equity real estate	**2,091,392**	1,810,972
Real estate owned	**194,225**	398,795
	2,285,617	2,209,767
Alternative investments:		
Private equity	**3,408,590**	3,004,550
Private debt	**1,143,928**	1,314,044
Venture capital	**432,551**	366,259
	4,985,069	4,684,853
Pension investments at fair value	**$ 52,739,728**	$ 48,826,643
Postemployment Healthcare investments:		
Premium Assistance:		
Pennsylvania Treasury Domestic Short-Term Investment Fund	**$ 10,081**	$ 30,872
Other domestic short-term	**81,688**	87,235
	91,769	118,107
Health Options Program:		
Pennsylvania Treasury Domestic Short-Term Investment Fund	**44,245**	25,222
Other domestic short-term	**46,433**	46,537
U.S. government and agency obligations	**15,877**	15,170
	106,555	86,929
Postemployment Healthcare investments at fair value	**$ 198,324**	$ 205,036

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 State Treasury Department is the custodian of the System's fund. State 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 health insurance program. These deposits are not required to be collateralized by statute or policy. These deposits totaled $46,433,000 at June 30, 2005 and are under the custody of M&T Bank that has an A- Deposit/Debt rating by Standard and Poor's and an A3 rating by Moody's.

ii. Investment Risks

The System's investments may be subject to various risks. Among these risks are custodial credit risk, credit risk, interest rate risk, and foreign currency risk. Each one of these risks is discussed in more detail below.

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 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.

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 Investor Services (Moody's), and Standard and Poor's (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 22% of the investment portfolio. The fixed income target allocation consists of:

Notes to Financial Statements (Continued)

- An allocation of 12.6% of the portfolio has been made to a domestic core plus segment of the fixed income asset class benchmarked to the Lehman Aggregate Bond Index and 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 5% of the portfolio has been made to the Treasury Inflation-Protected Securities (TIPS) segment of the fixed income asset class benchmarked to the Lehmam U.S. TIPS Index and composed of primarily government issued TIPS with an overall weighted-average NRSRO credit rating of AA or better;
- An allocation of 3.3% of the portfolio has been made to the global core plus fixed income asset class benchmarked to the Lehman Global Aggregate 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 A or better; and,
- An allocation of 1.1% of the portfolio has been made to the high yield fixed income asset class benchmarked to the Credit Suisse First Boston High Yield Bond Index that focuses on less liquid public non-investment grade fixed income securities with an overall weighted-average NRSRO credit rating of BB+ or less.

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, available from Fitch, Moody's and/or S&P that indicates the greatest degree of risk at June 30, 2005.

Quality Rating	(Dollar Amounts in Thousands) Market Value
AAA	$ 5,998,491
AA	958,565
A	1,168,562
BBB	1,034,282
BB and below	1,179,419
NR*	4,028,098
Total Exposed to Credit Risk	14,367,417
U.S. Government Guaranteed**	3,440,160
Total Fixed Income and Short-Term Investments	$ 17,807,577

* Not Rated securities include $1,346,850 in collective trust funds and $2,003,681 in the Pennsylvania (PA) Treasury Domestic Short-Term Investment Fund (STIF), a pooled investment fund for which ratings were unavailable. The STIF pool is comprised of short-term, high credit quality securities which are mainly U.S. Treasuries, agencies or repurchase agreements.

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

Notes to Financial Statements (Continued)

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 an effective duration range between 65 and 135 percent 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.

At June 30, 2005, the System's fixed income portfolio had the following option-adjusted durations by fixed income sector:

Investment Type	Option-Adjusted Duration	(Dollar Amounts in Thousands) Market Value
Domestic mortgage-backed securities	1.8	$ 4,898,249
U.S. government & agency obligations	6.3	2,959,042
Domestic corporate and taxable municipal bonds	3.3	3,178,674
Miscellaneous domestic fixed income	1.4	198,656
Fixed income collective trust funds	5.2	276,234
International fixed income	7.0	1,959,710
PA Treasury Domestic Short-Term Investment Fund	0.1	2,003,681
Total fixed income & PA Treasury Domestic Short-Term Investment Fund	3.4*	15,474,246
Total adjustment for futures contracts	1.2**	-
Total fixed income & PA Treasury Domestic Short-Term Investment Fund	4.6**	$ 15,474,246

* The option-adjusted duration of 3.4 for the total fixed income & PA Treasury Domestic Short-Term Investment Fund portfolio is calculated by weighting the option-adjusted duration of each investment type by market value.

** 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 fixed income & PA Treasury Domestic Short-Term Investment Fund portfolio duration upward by 1.2.

Notes to Financial Statements (Continued)

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, 2005, PSERS had the following non-U.S. currency exposure:

(Dollar Amounts in Thousands)

Currency	Equity	Fixed Income	Alternative Investments	Short-Term*	Total Market Value
Euro	$ 2,407,975	$ 874,542	$ 597,765	$ (166,373)	**$ 3,713,909**
British pound sterling	1,826,593	153,132	115,856	45,028	**2,140,609**
Japanese yen	1,704,872	73,125	-	328,334	**2,106,331**
Swiss franc	500,899	-	-	2,197	**503,096**
Canadian dollar	316,574	63,233	7,682	36,096	**423,585**
South Korean won	373,100	11,397	-	17,122	**401,619**
Hong Kong dollar	361,620	-	-	2,357	**363,977**
Australian dollar	299,085	75,856	-	(12,167)	**362,774**
Swedish krona	238,952	42,191	-	16,814	**297,957**
Other non-U.S. currencies	1,104,413	214,951	-	15,481	**1,334,845**
Total	$ 9,134,083	$ 1,508,427	$ 721,303	$ 284,889	**$11,648,702**

* Includes investment receivables and payables.

(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 issues 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 Commonwealth.

Notes to Financial Statements (Continued)

As of June 30, 2005 and 2004, 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, 2005 and 2004 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, 2005 and 2004.

Cash collateral is invested in the lending agent's short-term investment pool 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 27 days and 35 days at June 30, 2005 and 2004, respectively. The relationship between the maturities of the investment pool and the System's loans is affected by the maturities of the securities loans made by other entities that use the lending agent's pool, which the System cannot determine. 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, 2005, the fair value of loaned securities was $6,861,398,000 which includes $473,692,000 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 $7,110,014,000 of which $6,600,684,000 was cash. As of June 30, 2004, the fair value of loaned securities was $4,641,206,000 which includes $267,045,000 of loaned securities which are collateralized by securities and irrevocable letters of credit that are not included in the Statement of Plan Net Assets. The fair value of the associated collateral was $4,781,103,000 of which $4,505,428,000 was cash.

(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; 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. As the System generally enters into transactions only with high quality institutions, no losses associated with counterparty nonperformance on derivative financial instruments have been incurred. 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.

Notes to Financial Statements (Continued)

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.

The following table summarizes the aggregate notional or contractual amounts for the System's derivative financial instruments at June 30, 2005 and 2004 (in thousands):

	2005	2004
Futures contracts – long	**$ 14,086,616**	$ 6,307,135
Futures contracts – short	**6,651,721**	2,316,670
Foreign exchange forward and spot contracts, gross	**5,141,012**	2,671,009
Options – calls purchased	**-**	58,171
Options – puts purchased	**15,651**	-
Options – calls sold	**70,751**	58,691
Options – puts sold	**47,946**	25,791

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 or by cash held in segregated accounts by the System's custodial bank or short sale broker. 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, 2005 and 2004 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 System has authorized an investment manager to write covered call stock index option spreads up to a notional amount of $500,000,000.

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. The contracts reported above primarily include forwards. The $5,141,012,000 of foreign currency contracts outstanding at June 30, 2005 consist of "buy" contracts, which represent the U.S. dollar equivalents of commitments to purchase foreign currencies of $3,359,106,000 and "sell" contracts, which represent U.S. dollar equivalents of commitments to sell foreign currencies of $1,781,906,000.

Notes to Financial Statements (Continued)

The $2,671,009,000 of foreign currency contracts outstanding at June 30, 2004 consist of “buy” contracts of $1,757,164,000 and “sell” contracts of $913,845,000. The unrealized loss on contracts of $(7,825,000) and $(144,000) at June 30, 2005 and 2004, respectively, is included in the System’s net assets and represents the fair value of the contracts.

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, 2005 and 2004 is $2,357,739,000 and $1,903,901,000, 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.

Swap agreements are used to modify investment returns or interest rates on investments in the collective trust funds. Swap transactions involve the exchange of investment returns or interest rate payments without the exchange of the underlying principal amounts. These swaps expose the collective trust funds entering into these types of arrangements to credit risk in the event of nonperformance by counterparties.

(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% or 6.25% 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 1.43% at June 30, 2005, 0.50% at June 30, 2004 and 0.18% at June 30, 2003. The System’s contributions to SERS for the year ending June 30, 2005, 2004 and 2003 were $233,000, $84,000 and $10,000 respectively, which were equal to the required contributions each year.

Notes to Financial Statements (Continued)

(7)
Litigation and Contingencies

The System is subject to various threatened and pending lawsuits. 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.

Required Supplemental Schedule 1
Schedule of Funding Progress*

(Unaudited - see accompanying auditors' report)
(Dollar Amounts in Millions)

Valuation as of June 30	(1) Actuarial accrued liabilities (AAL)	(2) Actuarial value of assets	(3) (Funded) Unfunded actuarial accrued liabilities (FAAL) or UAAL (1) – (2)	(4) Ratio of assets to AAL (2) / (1)	(5) Covered payroll	(6) (FAAL) or UAAL as a percentage of covered payroll (3) / (5)
2004	# $ 57,123.0	$ 52,094.5	$ 5,028.5	91.2%	$ 10,030.7	$ 50.1%
2003	# 54,443.8	52,900.5	1,543.3	97.2%	9,652.9	16.0%
2002	# 51,796.5	54,296.4	(2,499.9)	104.8%	9,378.9	(26.7)%
2001	# 47,917.3	54,830.3	(6,913.0)	114.4%	9,414.9	(73.4)%
2000	39,822.8	49,293.0	(9,470.2)	123.8%	8,939.6	(105.9)%
1999	37,499.1	44,606.5	(7,107.4)	119.0%	8,247.6	(86.2)%

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

\# Includes the effects of Act 9 of 2001 and Act 38 of 2002.

See accompanying notes to required supplemental schedules.

Required Supplemental Schedule 2
Schedule of Employer Contributions*

(Unaudited - see accompanying auditors' report)
(Dollar Amounts in Thousands)

Year ended June 30	Annual required contributions	Percentage contributed
2005	$ 431,556	100%
2004	321,091	100%
2003	20,831	100%
2002	539	100%
2001	158,193	100%
2000	390,504	100%

The Board adopted all contribution rates as recommended by the Actuary pursuant to the prevailing provisions of the Retirement Code for each year.

* The amounts reported in the Schedule of Employer Contributions do not include premium assistance contributions.

See accompanying notes to required supplemental schedules.

Notes to Required Supplemental Schedules

June 30, 2005 and 2004

(Unaudited - see accompanying auditors' report)

(1)
Description of Schedule of Funding Progress

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.

(2)
Actuarial Assumptions and Methodologies

(a) Funding Method

An entry-age normal actuarial cost method of valuation is used in determining benefit liabilities and normal cost. The outstanding balance of the June 30, 2001 unfunded accrued liability is being amortized over a 10-year period commencing July 1, 2002, with level dollar funding. Changes in the unfunded accrued liability, including actuarial gains and losses, subsequent to June 30, 2001 are being amortized over a period of 10 years from the first day of July next following the change, with level dollar funding.

(b) Asset Valuation Method

For actuarial purposes, assets are valued using a five-year moving market average value that will recognize the 8.5% actuarial expected investment return immediately and spread the difference between actual and expected investment return (beginning with fiscal year ending June 30, 2001) over a period of five years (adopted as of June 30, 2001). Previously, PSERS immediately recognized interest and dividends when earned, and recognized realized and unrealized gains and losses on the market value of assets over a three-year period.

Notes to Required Supplemental Schedules (Continued)

(c) Actuarial Assumptions

Significant actuarial assumptions employed by the actuary for funding purposes as of June 30, 2004, the date of the most recent actuarial valuation include:

- Investment return – 8.5%, includes inflation at 3.5%
- Salary increases – 6.25%, which reflects an allowance for inflation of 3.5%, national productivity of 1%, and merit or seniority increases of 1.75%
- Amortization method – level dollar funding
- Remaining amortizations period – 10 years and 30 years in accordance with Act 40 of 2003
- 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 values 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 Reserve for Retirement 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. Consequently, all such determined benefits are fully funded.

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.

Supplemental Schedule 1
Schedule of Operating Expenses
Fiscal Year Ended June 30, 2005

(Dollar Amounts in Thousands)

	Administrative expenses (1)	Investment expenses (2)	Total
Personnel costs:			
Salaries and wages	$ 12,074	$ 3,032	$ 15,106
Social security contributions	938	226	1,164
Retirement contributions	181	52	233
Employees' insurance contributions	3,221	594	3,815
Other employee benefits	176	579	755
Total personnel costs	16,590	4,483	21,073
Operating costs:			
Investment managers' fees	-	183,566	183,566
Custodian fees	-	378	378
Specialized services	15,845	156	16,001
Rental of real estate, electricity	1,655	135	1,790
Consultant and legal fees	1,361	2,429	3,790
Treasury and other Commonwealth services	1,432	99	1,531
Postage	1,475	-	1,475
Contracted maintenance and repair services	406	19	425
Office supplies	356	3	359
Rental of equipment and software	1,001	57	1,058
Printing	624	-	624
Travel and training	230	39	269
Telecommunications	539	9	548
Equipment (not capitalized)	179	240	419
Miscellaneous expenses	350	1,064	1,414
Total operating expenses	25,453	188,194	213,647
Fixed charges:			
Furniture and fixtures	(76)	-	(76)
Depreciation	678	-	678
Total fixed charges	602	-	602
Total operating expenses	$ 42,645	$ 192,677	$ 235,322

(1) Includes administrative expenses of $1,876 related to Postemployment Healthcare Premium assistance and $8,099 related to Postemployment Healthcare Health Options Program for the fiscal year ended June 30, 2005.

(2) Does not include $23,728 in capitalized broker commissions for the fiscal year ended June 30, 2005.

Supplemental Schedule 2
Summary of Investment Expenses
Fiscal Year Ended June 30, 2005

(Dollar Amounts in Thousands)

	Assets under management*	Fees
External management		
Short-term **	$ -	$ 1,172
Domestic equity	7,271,000	21,803
International equity	10,133,000	30,179
Fixed income	9,126,000	14,457
Real estate	3,203,000	31,008
Private equity and debt	4,552,000	67,314
Venture capital	433,000	17,633
Total external management	34,718,000	183,566
Total internal management	17,307,000	5,024
Total investment management	$ 52,025,000	188,590
Custodian fees		378
Consultant and legal fees		2,429
Miscellaneous expenses		1,280
Total investment expenses		$ 192,677

* Net asset value at June 30, 2005.

** Short-term investments with a fair value of $2,004,000 are included in the other external and internal management assets under management amounts.

Supplemental Schedule 3
Schedule of Payments to Non-Investment Consultants
Fiscal Year Ended June 30, 2005

(Payment amounts greater than $50,000)

Consultant	Fees	Services Provided
CoreSource, Inc.	$ 6,422,446	Postemployment healthcare benefits administration and claims adjudication
Tier Technologies, Inc.	2,311,975	NPAS project development
The Segal Company	968,850	HOP consulting
Benecard Services, Inc.	759,812	Postemployment healthcare benefits and administration
Buck Consultants LLC	440,590	Pension benefit actuarial services
Independent Pharmaceutical Consultants, Inc.	137,293	Postemployment healthcare benefits administration
Independent Fiduciary Services, Inc.	111,875	Auditing services
Clifton Gunderson LLP	84,910	Financial audit of pension system and postemployment healthcare programs
L.R. Wechsler Ltd.	78,526	Information technology consulting