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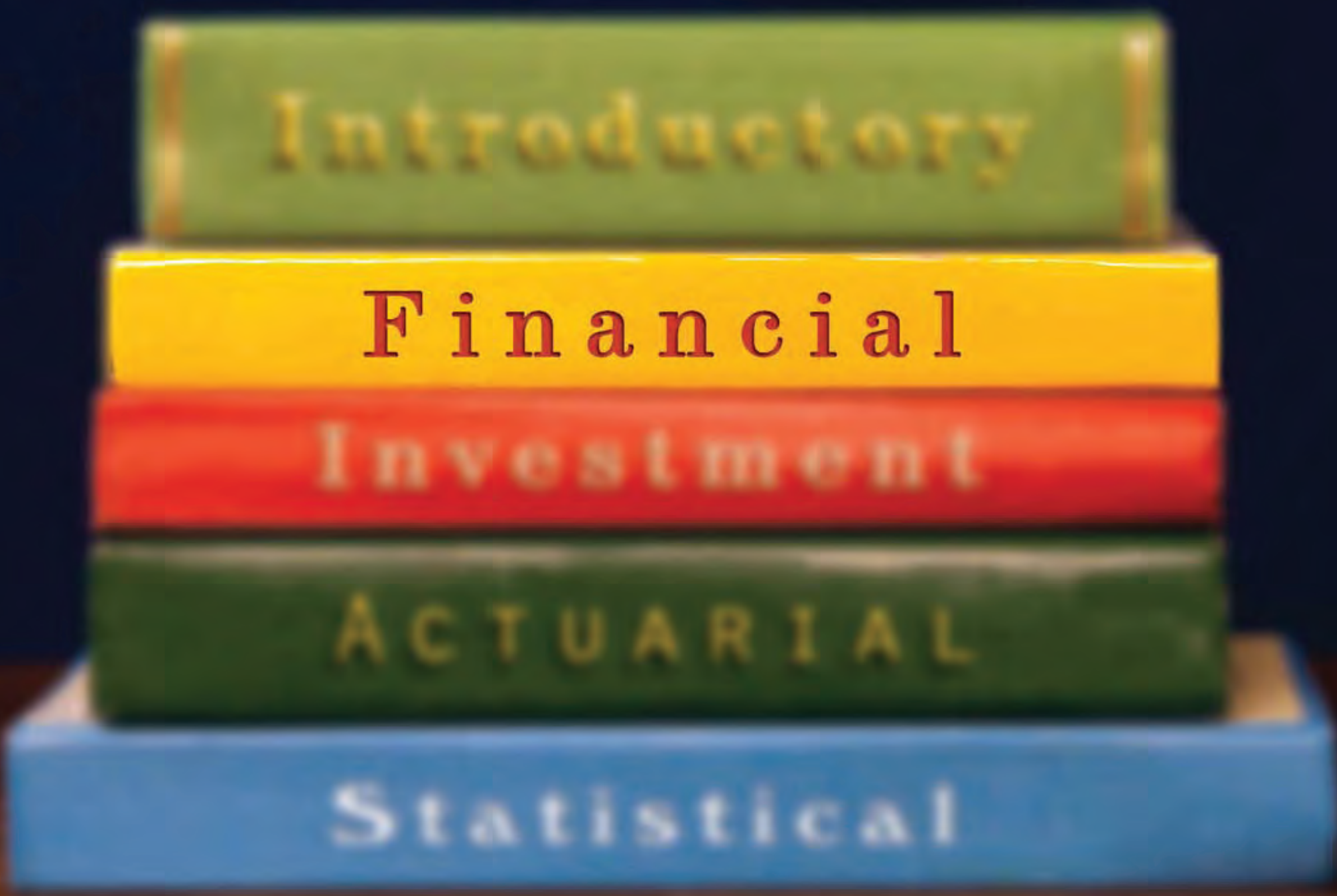
PSERS

Partners for your Future



Clifton Gunderson LLP
Certified Public Accountants & Consultants

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, 2010 and 2009, 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, 2010 and 2009, 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 financial statements, but is supplemental 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 supplemental 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 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.

The Chairman's Report, Introductory Section, Investment Section, Actuarial Section and Statistical Section as listed in the table of contents are presented for purposes of additional analysis and are not a required part of the basic financial statements. The Chairman's Report and 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.

Clifton Gunderson LLP

Baltimore, Maryland
September 23, 2010

Member of HLB International

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, 2010, provides a narrative summary of PSERS' 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 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, 2010, 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, 2009 to June 30, 2010, 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 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. 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 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

- The rate of return on investments was 14.59% for the fiscal year ended June 30, 2010 (FY 2010), -26.54% for the fiscal year ended June 30, 2009 (FY 2009) and -2.82% for the fiscal year ended, June 30, 2008 (FY 2008).

- PSERS' total plan net assets increased by $2.6 billion from $43.2 billion at June 30, 2009 to $45.8 billion at June 30, 2010. This increase was due to net investment income plus member and employer contributions exceeding the deductions for benefits and administrative expenses. The change in total plan net assets from June 30, 2008 to June 30, 2009 was a decrease in the amount of $19.5 billion from $62.7 billion at June 30, 2008 to $43.2 billion at June 30, 2009. This decrease was due to net investment loss and payment of pension benefits and administrative expenses combined that exceeded member and employer contributions.

- PSERS' funded ratio as of the latest actuarial valuation dated June 30, 2009 decreased from 86.0% at June 30, 2008 to 79.2% at June 30, 2009. This decrease is due to experience losses on investment assets, liability losses, assumption changes, and contributions that were less than the normal cost plus interest on the unfunded liability. The funded ratio at June 30, 2007 was 85.8%.

- Total member contributions increased from $1.09 billion in FY 2009 to $1.14 billion in FY 2010. Total member contributions also increased from FY 2008 to FY 2009. The increases for both periods were due to a slight increase in the average member contribution rate and an increase in the active member payroll. 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 $608.4 million during FY 2009 to $638.0 million in FY 2010. This increase is primarily attributable to a slight increase in the total employer contribution rate from 4.76% in FY 2009 to 4.78% in FY 2010 and an increase in the active member payroll. Total employer contributions decreased from FY 2008 to FY 2009 which was attributable to a decrease in the

Management's Discussion and Analysis (continued)

total employer contribution rate from 7.13% in FY 2008 to 4.76% in FY 2009.

- Total PSERS' benefit expense increased by $400 million from $4.9 billion in FY 2009 to $5.3 billion in FY 2010. 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. New retirements during FY 2010 outpaced those of FY 2009 by approximately 5.0%. Total PSERS' benefit expense remained consistent at $4.9 billion in FY 2009 and FY 2008 as higher monthly benefits from an increase in the overall number of retirees and beneficiaries receiving benefits were offset by lower lump sum payments due to a decrease in the number of new retirees in FY 2009.

- Total PSERS' administrative expenses decreased from $51.3 million for FY 2009 to $30.5 million in FY 2010. This overall decrease 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* (See Note 9). There was an increase of almost $3.0 million in administrative expenses for HOP due primarily to higher administrative fees for increased program participation. Total PSERS' administrative expenses increased by $2.0 million from $49.3 million in FY 2008 to $51.3 million in FY 2009. Administrative expenses were within PSERS' budgeted amounts for each of the fiscal 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 79.2% funded as of June 30, 2009.

The results of operations for FY 2010 will be reflected in the actuarial valuation for the year ended June 30, 2010. Due to the normal lag time for completion of the actuarial valuation, the resulting funded status will be available at the end of the 2010 calendar year and will be reported in the financial statements for the fiscal year ended June 30, 2011 (FY 2011). Based on the investment performance for the five-year period ended June 30, 2010, which is below the investment rate of return assumption during that time period, the funded ratio at June 30, 2010 is expected to decrease. PSERS' State Accumulation Account had a negative balance at June 30, 2010 and 2009 (See Note 3). Employer contributions and investment earnings will be used to reduce the deficit in this Account in the future. A twenty-year history of PSERS' funded status follows.

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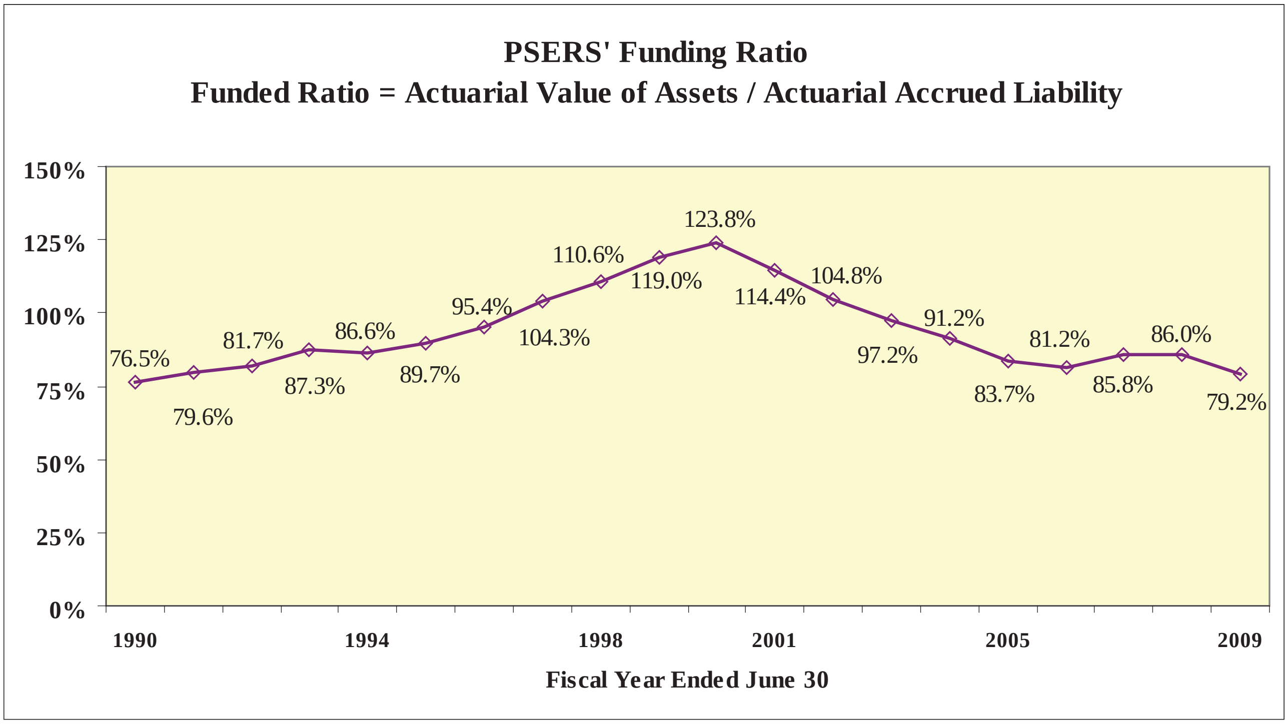
Management's Discussion and Analysis (continued)



Analysis of Plan Net Assets

(Dollar Amounts in Thousands)

Summary of Plan Net Assets	FY 2010	Increase (Decrease)	FY 2009	Increase (Decrease)	FY 2008
Assets:					
Receivables	**$ 1,065,061**	$ (289,940)	$ 1,355,001	$ (908,385)	$ 2,263,386
Investments	**46,504,268**	3,160,333	43,343,935	(20,548,285)	63,892,220
Securities lending collateral pool	**1,524,235**	(67,486)	1,591,720	(3,255,279)	4,846,999
Capital assets	**19,215**	18,685	530	(135)	665
Total Assets	**49,112,779**	2,821,592	46,291,186	(24,712,084)	71,003,270
Liabilities:					
Payables and other liabilities	**1,751,017**	258,591	1,492,426	(2,005,221)	3,497,647
Obligations under securities lending	**1,524,234**	(67,486)	1,591,720	(3,255,279)	4,846,999
Total Liabilities	**3,275,251**	191,105	3,084,146	(5,260,500)	8,344,646
Plan Net Assets	**$ 45,837,527**	$ 2,630,487	$ 43,207,040	$ (19,451,584)	$ 62,658,624

Summary of Changes in Plan Net Assets	FY 2010	Increase (Decrease)	FY 2009	Increase (Decrease)	FY 2008
Additions:					
Contributions	**$ 1,815,166**	$ 85,309	$ 1,729,857	$ (172,579)	$ 1,902,436
Net investment income (loss)	**6,114,988**	22,313,300	(16,198,312)	(14,422,727)	(1,775,585)
Total Additions	**7,930,154**	22,398,609	(14,468,455)	(14,595,306)	126,851
Deductions:					
Benefit expense	**5,269,175**	337,321	4,931,854	(9,827)	4,941,681
Administrative expenses	**30,492**	(20,783)	51,275	2,025	49,250
Total Deductions	**5,299,667**	316,538	4,983,129	(7,802)	4,990,931
Changes in Plan Net Assets	**$ 2,630,487**	$ 22,082,071	$ (19,451,584)	$ (14,587,504)	$ (4,864,080)

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.

For FY 2010, PSERS' rate of return on investments was 14.59% which exceeded PSERS' total fund Policy Index of 10.87%. The Policy Index, which is based on the Board-established asset allocation structure, is a custom benchmark designed to generate a return that meets the actuarial rate of return assumption. Net investment income exceeded $6.1 billion in FY 2010 compared to a net investment loss of -$16.2 billion in FY 2009 as the U.S. recovered from the worst economic contraction since the Great Depression. In FY 2009 the Fund experienced a -26.54% return during a very challenging fiscal year. The U.S. Gross Domestic Product (GDP) increased in all four quarters of FY 2010 and the U.S. unemployment rate stabilized after increasing significantly in FY 2009. Internationally, emerging markets, such as China and India, have largely recovered from the economic downturn while developed markets, such as the United Kingdom and France, have rebounded but have not returned to economic levels prior to the downturn.

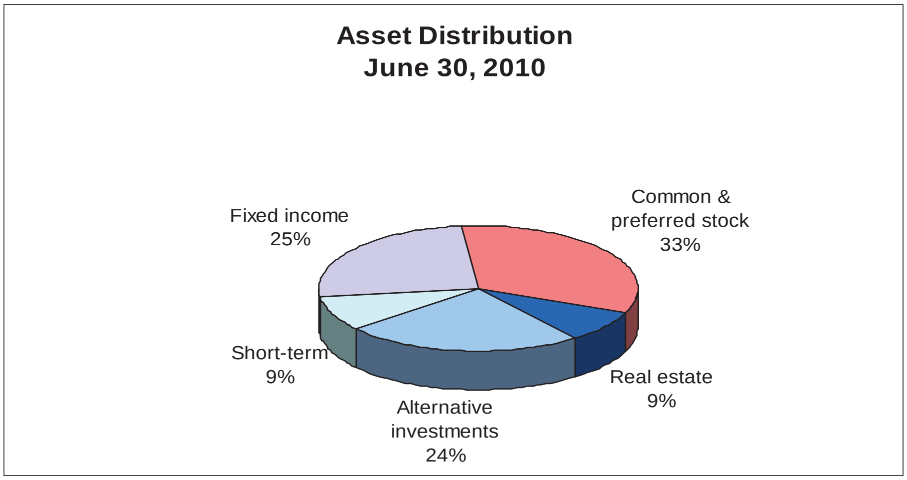
The annualized rate of return over the past three and five-year periods ended June 30, 2010 was -6.48% and 2.99%, respectively. The return for the three-year period trailed the total fund Policy Index return by 171 basis points while the return for the five-year period exceeded the total fund Policy Index return by 24 basis points. The annualized rate of return for the ten and twenty-five-year periods ended June 30, 2010 was 3.51% and 8.83%, respectively.

PSERS' long-term actuarial investment rate of return assumption was 8.00% at June 30, 2010. PSERS' Board of Trustees (Board) decreased the actuarial investment rate of return assumption from 8.50% to 8.25% effective for the June 30, 2008 actuarial valuation. The Board also decreased the rate of return assumption further from 8.25% to 8.00% for the June 30, 2009 actuarial valuation. The changes made by the Board lowered PSERS' rate of return assumption to the median investment rate of return assumption used by most public pension funds and provided a more realistic outlook on the future earnings potential of the Fund. The 0.5% decrease in the rate of return assumption allowed PSERS to modify its asset allocation plan during FY 2009 to achieve its new return target with lower overall risk. PSERS continued to monitor and endeavored to reduce risk in its investment portfolio during FY 2010.

The asset distribution of PSERS' investment portfolio at June 30, 2010, 2009 and 2008, at fair value, and including postemployment healthcare assets, is presented in the table at the bottom of the page.

	(Dollar Amounts in Thousands)					
Asset Class	**2010**	**%**	2009	%	2008	%
Short-term	**$ 4,163,515**	**9.0**	$ 5,398,729	12.5	$ 4,215,171	6.6
Fixed income	**11,873,202**	**25.5**	11,333,549	26.2	17,984,233	28.2
Common and preferred stock	**15,316,957**	**32.9**	13,883,372	32.0	27,875,324	43.6
Real estate	**3,973,873**	**8.6**	3,699,353	8.5	4,951,840	7.8
Alternative investments	**11,176,721**	**24.0**	9,028,932	20.8	8,865,652	13.8
Total	**$ 46,504,268**	**100.0**	$ 43,343,935	100.0	$ 63,892,220	100.0

Management's Discussion and Analysis (continued)



Short-term investments (cash and cash equivalents) decreased by $1.2 billion from $5.4 billion at June 30, 2009 to $4.2 billion at June 30, 2010. Due to an improved liquidity situation in the financial markets, PSERS was able to substantially reduce its cash management level during FY 2010. Fixed income investments increased by $600 million from $11.3 billion at June 30, 2009 to $11.9 billion at June 30, 2010 mostly due to market value appreciation which was partially offset by allocation reductions. Common and preferred stock investments also increased by $1.4 billion from $13.9 billion at June 30, 2009 to $15.3 billion at June 30, 2010. The upturn in this asset category was mainly the result of positive returns in the domestic and international equity markets which were counteracted to a certain extent by allocation decreases to the asset class. Real estate investments rose by $300 million from $3.7 billion at June 30, 2009 to $4.0 billion at June 30, 2010 as a result of contributions to new and existing partnerships offsetting continuing declines in value of partnership investments. Alternative investments increased by $2.2 billion from $9.0 billion at June 30, 2009 to $11.2 billion at June 30, 2010 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 $1.2 billion from $4.2 billion at June 30, 2008 to $5.4 billion at June 30, 2009. Due to the uncertainties in the equity and fixed income markets, PSERS built up its short-term investment fund during FY 2009. During FY 2009, PSERS brought the management of its short-term investment fund in-house. This fund had been previously managed by the Pennsylvania Treasury Department. Fixed income investments fell by $6.7 billion from $18.0 billion at June 30, 2008 to $11.3 billion at June 30, 2009 because of allocation reductions as well as market value depreciation. Similarly, common and preferred stock investments dropped by $14.0 billion from $27.9 billion at June 30, 2008 to $13.9 billion at June 30, 2009. The decrease was primarily the result of significant deterioration in the domestic and international equity markets in addition to funds being transferred out of the asset class. Real estate investments declined by $1.3 billion from $5.0 billion at June 30, 2008 to $3.7 billion at June 30, 2009 due to substantial market value depreciation which was offset in part by net allocation increases to new and existing real estate partnerships. Alternative investments rose by $100 million from $8.9 billion at June 30, 2008 to $9.0 billion at June 30, 2009 as a result of contributions to new and existing partnerships which were almost entirely negated by the downturn in value of partnership portfolio holdings.

Securities Lending

Securities lending collateral pool and obligations under securities lending decreased only slightly from $1.6 billion at June 30, 2009 to $1.5 billion at June 30, 2010. The collateral pool, however, dropped from $4.8 billion at June 30, 2008 to $1.6 billion at June 30, 2009 due to a significant decline in both the number of securities on loan and the market value of those securities for which cash collateral was provided.

The System experienced a net gain of $8.5 million from securities lending activities in FY 2010 compared to a net loss of $26.8 million in FY 2009. The loss from securities lending activities for FY 2009 was the result of the decline in valuation of certain securities purchased with cash collateral by the lending agent. Absent this factor, the System would have experienced a net gain of $22.9 million or almost three times that of FY 2010. After the financial institution collapse in the Fall of 2008, it became increasingly difficult for the lending agent to attain earnings on investing cash collateral in excess of the rates being rebated to the borrowers. This spread fell from 93 basis points in FY 2009 to 35 basis points in FY 2010. Because

Management's Discussion and Analysis (continued)

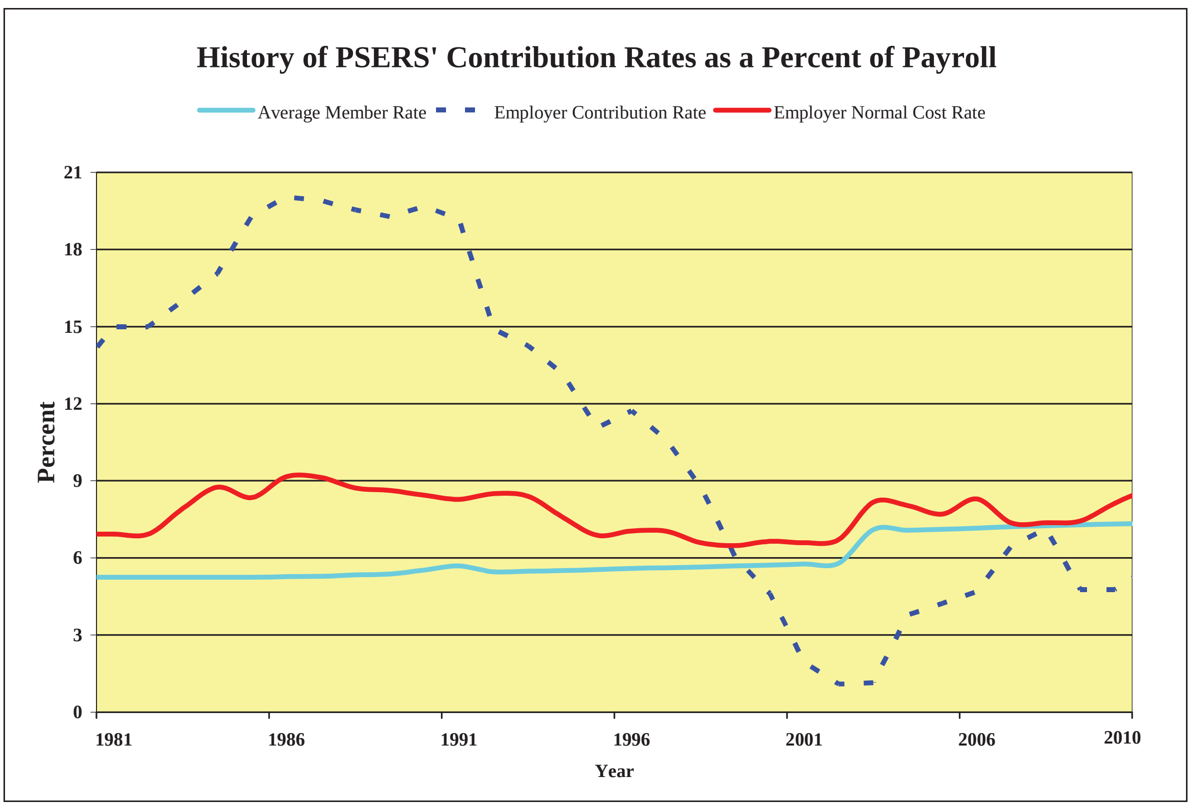
of the heightened risk associated with the sudden downturn in the market in FY 2009, restrictions were placed on the lending of particular securities in PSERS' portfolio and the risk profile of the investments permitted in the collateral pool was reduced.

Contributions

Employer contributions increased from $608.4 million in FY 2009 to $638.0 million in FY 2010 due to the slight increase in the total employer contribution rate from 4.76% in FY 2009 to 4.78% in FY 2010 and an increase in the active member payroll.

Total member contributions increased from $1.09 billion in FY 2009 to $1.14 billion in FY 2010 due to increases in both the average member contribution rate and active member payroll for pension and increased participation in the HOP. The average member contribution rate for pension increased from 7.29% in FY 2009 to 7.32% in FY 2010. Total member contributions increased from $1.04 billion in FY 2008 to $1.09 billion in FY 2009 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 7.25% in FY 2008 to 7.29% in FY 2009. A thirty-year history of PSERS' contribution rates is presented at the bottom of the page.

As a result of improved remittances from PSERS' employers during FY 2010, accounts receivable balances for member and employer contributions were slightly lower at June 30, 2010 compared to June 30, 2009 despite increased contributions in FY 2010. Total member and employer accounts receivable at June 30, 2010 were $450.6 million compared to $454.1 million as of June 30, 2009.



Management's Discussion and Analysis (continued)

Projected Fiscal Year 2012-2013 (FY 2013) Employer Contribution Rate Increase

The current funding issue confronting PSERS represents the greatest challenge the Agency has faced in its history. The funding issue, commonly referred to as the "rate spike" or "rate plateau," refers to the significant increase in the projected employer contribution rate in FY 2013 and following years, that is paid by school employers and the Commonwealth to PSERS to fund pension benefits.

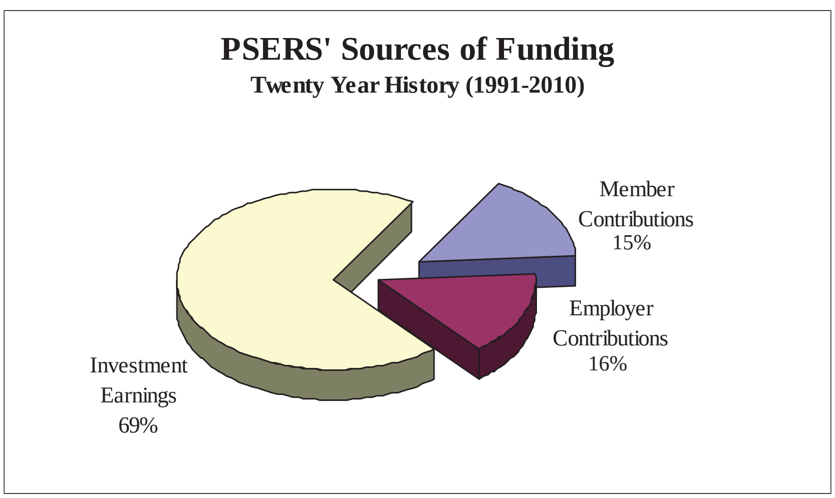
The projected rate spike was first reflected in the June 30, 2003 actuarial valuation. This valuation took into consideration the actuarial impact of the pension benefit enhancement enacted in 2001 (Act 9 of 2001), a major downturn in the investment markets between 2001 and 2003, and a series of legislative actions (Act 38 of 2002 and Act 40 of 2003) that changed the basic funding methodologies for PSERS and suppressed the employer contribution rate below the employer normal cost rate and average member contribution rate as displayed in the previous chart on the History of PSERS' Contribution Rates. The employer normal cost is the expected contribution from employers to fund on-going liabilities if all other actuarial assumptions are met and the unfunded liability is zero.

Previously, PSERS' investment returns for the four years ended June 30, 2007 had reduced the projected FY 2013 employer contribution rate by more than 50%, from a high of 27.73% to a projected rate of 11.23% as of the June 30, 2007 valuation. Over the past several years, however, the sharp downturn in the economy and financial markets that contributed to the -26.54% return for FY 2009 and the -2.82% investment return for FY 2008 has essentially eliminated any past progress made in reducing the FY 2013 projected rate increase. Based on the June 30, 2009 actuarial valuation, the projected rate in FY 2013 now exceeds the original projection of 27.73% and peaks in excess of 33% in FY 2015. The majority of the projected FY 2013 rate increase is devoted to the payment of unfunded liabilities that have accumulated since 2001.

Several pieces of legislation have been introduced to address the funding issue. House Bill (HB) 2497, which includes prospective benefits reductions for future new employees, actuarial smoothing techniques, and rate collars to control the level of annual increases in the employer contribution rate, has passed the Pennsylvania House of Representatives. The Pennsylvania Senate passed a modified version of HB2497 and sent the revised bill back to the House. As of the publication date of this report, the bill was waiting for further action in the Pennsylvania House. PSERS will continue to monitor pension legislation and provide analytical and technical support for new bills and/or amendments to existing bills.

Investment Income

Net investment income (loss) changed by $22.3 billion from -$16.2 billion in FY 2009 to $6.1 billion in FY 2010, which is consistent with the increase in the investment rate of return from -26.54% for FY 2009 to 14.59% for FY 2010. Net investment income (loss) changed by $14.4 billion from -$1.8 billion in FY 2008 to -$16.2 billion in FY 2009, which correlates to the decrease in the investment rate of return from -2.82% for FY 2008 to -26.54% for FY 2009. As depicted in the following chart, investment earnings provided 69% of PSERS' funding over the past 20 years. Net investment income (loss) 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)

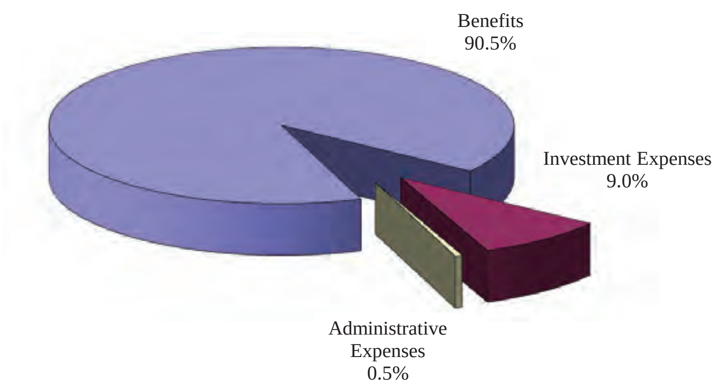
Total PSERS' Benefits and Expenses

The primary source of expense during FY 2010 was for the payment of benefits totaling $5.3 billion. The breakdown is $5.0 billion for Pension, $89.9 million for PA and $193.3 million for HOP benefits. The following chart illustrates the significant portion of expenses attributable to benefit payments. Total PSERS' benefit expense increased from $4.9 billion in FY 2009 to $5.3 billion in FY 2010. 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. As a result of these factors pension benefits payable at June 30, 2010 increased to $540.0 million compared to $345.7 million at June 30, 2009. New retirements during FY 2010 outpaced the number from FY 2009 by approximately 5.0%. Benefit expenses remained consistent from FY 2008 to FY 2009 due to higher monthly benefits from the increase in the overall number of retirees and beneficiaries being offset by lower lump sum payments due to the decrease in the number of new retirees in FY 2009.

Investment expenses increased by $44.7 million from $477.6 million in FY 2009 to $522.3 million in FY 2010 chiefly due to a rise in management fees in the public market asset classes. The growth in these fees was primarily a result of certain investment managers earning higher performance incentives in FY 2010 than in FY 2009. Investment expenses increased by $78.5 million from $399.1 million in FY 2008 to $477.6 million in FY 2009 mainly due to a rise in management fees in the private market asset classes. The higher fees were essentially the result of new investments made in alternative investment and real estate partnerships during FY 2009 and FY 2008. Investment expenses are reported as a reduction in net investment income (loss) on the Statements of Changes in Plan Net Assets.

Administrative expenses decreased by $20.8 million from $51.3 million during FY 2009 compared to $30.5 million during FY 2010. This decrease was primarily caused by capitalization of previously expensed GASB 51 qualifying costs for computer systems development in the amount of $23.8 million. This decrease was partially offset by an increase in costs due to increasing membership within the member funded HOP. Administrative expenses increased by $2 million from $49.3 million during FY 2008 compared to $51.3 million during FY 2009. The increase was attributable to greater costs and increasing membership within the member funded HOP.

Total PSERS' Benefits and Expenses
Fiscal Year Ended June 30, 2010



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 supplemental 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)

- Total plan net assets increased by $11.7 million in FY 2010 due to Employer contributions exceeding the payment of benefits and associated administrative expenses. The change from June 30, 2008 to June 30, 2009 was an increase of $9.3 million also due to contributions exceeding expenses.

- Total receivables decreased slightly from $38.3 million at June 30, 2009 to $37.5 million at June 30, 2010 due to improved employer collections.

- Investments increased from $67.3 million at June 30, 2009 to $79.8 million at June 30, 2010 due to net cash flows of contributions exceeding expenditures.

Health Options Program (HOP)

- Total plan net assets increased by $15.8 million in FY 2010 primarily due to positive claims experiences serving to increase short-term investments. The change from June 30, 2008 to June 30, 2009 was an increase of $17.0 million also due to positive claims experience.

- Total receivables increased from $9.6 million at June 30, 2009 to $13.4 million at June 30, 2010. The increase is tied primarily to an increase in participation and expected amount due from the Centers for Medicare & Medicaid Services (CMS) for the 2009 Plan Year.

- Investments increased from $127.0 million at June 30, 2009 to $142.4 million at June 30, 2010 due to positive claims experiences causing cash flow to exceed expenditures.

- Total liabilities increased 11.5% from June 30, 2009 to June 30, 2010. The increase is due to increased participation in the program and due to payment timing for an invoice for prescription drug benefits.

Contributions

- Total employer contributions for PA increased from $92.5 million in FY 2009 to $102.7 million in FY 2010 due to the increase in employer contribution rate from 0.76% in FY 2009 to 0.78% in FY 2010 as well as an increase in the active member payroll.

- Total member and CMS contributions for HOP increased from $210.4 million in FY 2009 to $225.1 million in FY 2010. This increase is representative of the 7.0% increase in plan participation.

Investment Income

- Total investment income for PA decreased from $1.9 million in FY 2009 to $0.9 million in FY 2010. The decrease is due to declining short-term interest rates from FY 2009 to FY 2010.

- Investment income for HOP decreased from $1.5 million in FY 2009 to $0.4 million in FY 2010. This decrease is due to lower rates of return on short-term investments.

Benefits and Expenses

- Overall expenses for PA increased from $85.0 million in FY 2009 to $91.9 million in FY 2010. This increase is primarily due to the increase in number of members receiving premium assistance benefits.

- Overall expenses for HOP increased from $194.9 million in FY 2009 to $209.8 million in FY 2010. The increase is due to increased participation in the program.

Management's Discussion and Analysis (continued)

Premium Assistance

Summary of Plan Net Assets

(Dollar Amounts in Thousands)

Assets:	FY 2010	Increase (Decrease)	FY 2009	Increase (Decrease)	FY 2008
Receivables	**$ 37,540**	$ (787)	$ 38,327	$ 9,122	$ 29,205
Investments	**79,848**	12,580	67,268	(132)	67,400
Total Assets	**117,388**	11,793	105,595	8,990	96,605
Liabilities					
Payables and other liabilities	**557**	76	481	(339)	820
Total Liabilities	**557**	76	481	(339)	820
Plan Net Assets	**$ 116,831**	$ 11,717	$ 105,114	$ 9,329	$ 95,785

Summary of Changes in Plan Net Assets

Additions:	FY 2010	Increase (Decrease)	FY 2009	Increase (Decrease)	FY 2008
Contributions	**$ 102,703**	$ 10,210	$ 92,493	$ 11,176	$ 81,317
Net investment income	**869**	(992)	1,861	(894)	2,755
Total Additions	**103,572**	9,218	94,354	10,282	84,072
Deductions:					
Benefit expenses	**89,911**	6,705	83,206	(1,129)	84,335
Administrative expenses	**1,944**	125	1,819	575	1,244
Total Deductions	**91,855**	6,830	85,025	(554)	85,579
Changes in Plan Net Assets	**$ 11,717**	$ 2,388	$ 9,329	$ 10,836	$ (1,507)

Health Options Program

Summary of Plan Net Assets

(Dollar Amounts in Thousands)

Assets:	FY 2010	Increase (Decrease)	FY 2009	Increase (Decrease)	FY 2008
Receivables	**$ 13,418**	$ 3,844	$ 9,574	$ 3,604	$ 5,970
Investments	**142,436**	15,393	127,043	12,702	114,341
Total Assets	**155,854**	19,237	136,617	16,306	120,311
Liabilities:					
Payables and other liabilities	**33,633**	3,462	30,171	(727)	30,898
Total Liabilities	**33,633**	3,462	30,171	(727)	30,898
Plan Net Assets	**$ 122,221**	$ 15,775	$ 106,446	$ 17,033	$ 89,413

Summary of Changes in Plan Net Assets

Additions:	FY 2010	Increase (Decrease)	FY 2009	Increase (Decrease)	FY 2008
Contributions	**$ 225,085**	$ 14,728	$ 210,357	$ 22,368	$ 187,989
Net investment income	**440**	(1,088)	1,528	(2,760)	4,288
Total Additions	**225,525**	13,640	211,885	19,608	192,277
Deductions:					
Benefit expenses	**193,307**	12,272	181,035	5,899	175,136
Administrative expenses	**16,443**	2,626	13,817	1,674	12,143
Total Deductions	**209,750**	14,898	194,852	7,573	187,279
Changes in Plan Net Assets	**$ 15,775**	$ (1,258)	$ 17,033	$ 12,035	$ 4,998

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Statements of Plan Net Assets
June 30, 2010 and 2009
(Dollar Amounts in Thousands)

	2010			
		Postemployment Healthcare		
	Pension	Premium Assistance	Health Options Program	Totals
Assets:				
Receivables:				
Members	$ 240,569	$ 6,597	$ 40	$ 247,206
Employers	173,258	30,184	-	203,442
Investment income	252,495	289	38	252,822
Investment proceeds	347,033	-	-	347,033
Ctrs for Medicare & Medicaid Svcs	-	-	6,231	6,231
Miscellaneous	748	470	7,109	8,327
Total Receivables	1,014,103	37,540	13,418	1,065,061
Investments, at fair value:				
Short-term	3,941,231	79,848	142,436	4,163,515
Fixed income	11,873,202	-	-	11,873,202
Common and preferred stock	15,316,957	-	-	15,316,957
Real estate	3,973,873	-	-	3,973,873
Alternative investments	11,176,721	-	-	11,176,721
Total Investments	46,281,984	79,848	142,436	46,504,268
Securities lending collateral pool	1,524,234	-	-	1,524,234
Capital assets (net of accumulated depreciation of $16,641)	19,215	-	-	19,215
Total Assets	48,839,536	117,388	155,854	49,112,778
Liabilities:				
Accounts payable and accrued expenses	77,048	361	1,287	78,696
Benefits payable	540,011	196	16,047	556,254
Premium advances	-	-	16,299	16,299
Investment purchases and other liabilities	1,099,768	-	-	1,099,768
Obligations under securities lending	1,524,234	-	-	1,524,234
Total Liabilities	3,241,061	557	33,633	3,275,251
Net assets held in trust for pension and postemployment healthcare benefits	$ 45,598,475	$ 116,831	$ 122,221	$ 45,837,527

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

Statements of Plan Net Assets
June 30, 2010 and 2009
(Dollar Amounts in Thousands)

	2009			
		Postemployment Healthcare		
	Pension	Premium Assistance	Health Options Program	Totals
Assets:				
Receivables:				
Members	$ 244,327	$ 6,353	$ 30	$ 250,710
Employers	172,099	31,289	-	203,388
Investment income	362,058	201	57	362,316
Investment proceeds	522,405	-	-	522,405
Ctrs for Medicare & Medicaid Svcs	-	-	3,339	3,339
Miscellaneous	6,211	484	6,148	12,843
Total Receivables	1,307,100	38,327	9,574	1,355,001
Investments, at fair value:				
Short-term	5,204,418	67,268	127,043	5,398,729
Fixed income	11,333,549	-	-	11,333,549
Common and preferred stock	13,883,372	-	-	13,883,372
Real estate	3,699,353	-	-	3,699,353
Alternative investments	9,028,932	-	-	9,028,932
Total Investments	43,149,624	67,268	127,043	43,343,935
Securities lending collateral pool	1,591,720	-	-	1,591,720
Capital assets (net of accumulated depreciation of $10,933)	530	-	-	530
Total Assets	46,048,974	105,595	136,617	46,291,186
Liabilities:				
Accounts payable and accrued expenses	81,483	338	1,575	83,396
Benefits payable	345,669	143	13,182	358,994
Premium advances	-	-	15,414	15,414
Investment purchases and other liabilities	1,034,622	-	-	1,034,622
Obligations under securities lending	1,591,720	-	-	1,591,720
Total Liabilities	3,053,494	481	30,171	3,084,146
Net assets held in trust for pension and postemployment healthcare benefits	$ 42,995,480	$ 105,114	$ 106,446	$ 43,207,040

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

Statements of Changes in Plan Net Assets
Years Ended June 30, 2010 and 2009
(Dollar Amounts in Thousands)

	2010			
		Postemployment Healthcare		
	Pension	Premium Assistance	Health Options Program	Totals
Additions:				
Contributions:				
Members	$ 952,047	$ -	$ 191,184	$ 1,143,231
Employers	535,331	102,703	-	638,034
Ctrs for Medicare & Medicaid Svcs	-	-	33,901	33,901
Total contributions	1,487,378	102,703	225,085	1,815,166
Investment income:				
From investing activities:				
Net appreciation (depreciation) in fair value of investments	5,142,243	(1,039)	-	5,141,204
Short-term	19,015	1,955	440	21,410
Fixed income	440,358	-	-	440,358
Common and preferred stock	784,431	-	-	784,431
Real estate	62,273	-	-	62,273
Alternative investments	179,116	-	-	179,116
Total investment activity income	6,627,436	916	440	6,628,792
Investment expenses	(522,268)	(47)	-	(522,315)
Net income from investing activities	6,105,168	869	440	6,106,477
From securities lending activities:				
Securities lending income	9,574	-	-	9,574
Securities lending expense	(1,063)	-	-	(1,063)
Net income from securities lending activities	8,511	-	-	8,511
Total net investment income	6,113,679	869	440	6,114,988
Total Additions	7,601,057	103,572	225,525	7,930,154
Deductions:				
Benefits	4,962,222	89,911	193,307	5,245,440
Refunds of contributions	16,720	-	-	16,720
Net transfer to State Employees' Retirement System	7,015	-	-	7,015
Administrative expenses	12,105	1,944	16,443	30,492
Total Deductions	4,998,062	91,855	209,750	5,299,667
Net increase	2,602,995	11,717	15,775	2,630,487
Net assets held in trust for pension and postemployment healthcare benefits:				
Balance, beginning of year	42,995,480	105,114	106,446	43,207,040
Balance, end of year	$ 45,598,475	$ 116,831	$ 122,221	$ 45,837,527

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

Statements of Changes in Plan Net Assets
Years Ended June 30, 2010 and 2009
(Dollar Amounts in Thousands)

	2009			
		Postemployment Healthcare		
	Pension	Premium Assistance	Health Options Program	Totals
Additions:				
Contributions:				
Members	$ 911,118	$ -	$ 178,801	$ 1,089,919
Employers	515,889	92,493	-	608,382
Ctrs for Medicare & Medicaid Svcs	-	-	31,556	31,556
Total contributions	1,427,007	92,493	210,357	1,729,857
Investment income:				
From investing activities:				
Net depreciation in fair value of investments	(17,007,821)	(363)	-	(17,008,184)
Short-term	55,161	2,269	1,528	58,958
Fixed income	587,007	-	-	587,007
Common and preferred stock	500,001	-	-	500,001
Real estate	92,515	-	-	92,515
Alternative investments	75,776	-	-	75,776
Total investment activity income (loss)	(15,697,361)	1,906	1,528	(15,693,927)
Investment expenses	(477,520)	(45)	-	(477,565)
Net income (loss) from investing activities	(16,174,881)	1,861	1,528	(16,171,492)
From securities lending activities:				
Securities lending income	55,574	-	-	55,574
Securities lending expense	(82,394)	-	-	(82,394)
Net loss from securities lending activities	(26,820)	-	-	(26,820)
Total net investment income (loss)	(16,201,701)	1,861	1,528	(16,198,312)
Total Additions	(14,774,694)	94,354	211,885	(14,468,455)
Deductions:				
Benefits	4,639,297	83,206	181,035	4,903,538
Refunds of contributions	20,369	-	-	20,369
Net transfer to State Employees' Retirement System	7,947	-	-	7,947
Administrative expenses	35,639	1,819	13,817	51,275
Total Deductions	4,703,252	85,025	194,852	4,983,129
Net increase (decrease)	(19,477,946)	9,329	17,033	(19,451,584)
Net assets held in trust for pension and postemployment healthcare benefits:				
Balance, beginning of year	62,473,426	95,785	89,413	62,658,624
Balance, end of year	$ 42,995,480	$ 105,114	$ 106,446	$ 43,207,040

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

Notes to Financial Statements
Years Ended June 30, 2010 and 2009

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, 2010, there were 747 participating employers, generally school districts. Membership as of June 30, 2009, 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.

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.

Currently employed members:		
Vested	185,000	
Nonvested	94,000	
Total currently employed members		**279,000**
Retirees and beneficiaries currently receiving benefits	178,000	
Inactive members and vestees entitled to but not receiving benefits	104,000	
Total retirees and other members		**282,000**
Total number of members		**561,000**

Notes to Financial Statements (continued)

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%**

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.

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

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 is 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.

Contribution rates for active members are set by law (redefined with the provisions of Act 9 of 2001) and are dependent upon members' class. The contribution rates based on qualified member compensation for virtually all members are presented in the table at the top of this page.

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.

The total contribution rate for the employers and the Commonwealth was 4.78% and 4.76% of qualified compensation for the years ended June 30, 2010 and 2009, 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 (PA). The PA contribution rate is set at a level necessary to establish reserves sufficient to provide PA 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 PA was 0.78% and 0.76% for the years ended June 30, 2010 and 2009, respectively.

Notes to Financial Statements (continued)

iii. Funding Status and Annual Required Contributions (ARC)

As of June 30, 2009, the most recent actuarial valuation, the plan was 79.2% funded. The actuarial accrued liability for benefits was $75.6 billion, and the actuarial value of assets was $59.9 billion, resulting in an unfunded accrued liability of $15.7 billion. The covered payroll of active members was $12.5 billion and the ratio of the unfunded actuarial accrued liability to the covered payroll was 125.7%.

For fiscal year ended June 30, 2010, the ARC was $1.93 billion. The actual employer contributions, net of purchase of service contributions, for fiscal year ended June 30, 2010 was $527.2 million resulting in a 27% contributed rate.

The Schedule of Funding Progress and Schedule of Employer Contributions included as Required Supplemental 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 of valuation is used in determining benefit liabilities and normal cost. The outstanding balance of the unfunded accrued liability as of June 30, 2001 and the decrease in the unfunded accrued liability due to the actuarial asset method change provided by Act 38 continue to be amortized over a 10 year period, with level dollar funding, beginning July 1, 2002. The increases in the unfunded accrued liability due to the July 1, 2002 and July 1, 2003 cost-of-living adjustments provided by Act 38 were both recognized at June 30, 2002 and continue to be amortized over a 10 year period, with level dollar funding starting on July 1, 2003 and July 1, 2004, respectively. All other changes in the unfunded accrued liability at June 30, 2001 and June 30, 2002, including the Act 9 benefit changes, are amortized over a 30 year period, with level dollar funding starting on July 1, 2002, and July 1, 2003, respectively. Post June 30, 2002 gains and losses, and changes in the unfunded accrued liability resulting from changes in actuarial assumptions and methods, are amortized over a 30 year period with level dollar funding. In addition Act 40 also provided a 4.00% floor on the employer pension contribution rate.

For purposes of determining the annual required contributions under Governmental Accounting Standards Board 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) in fiscal years in which the amortization requirements of the PSERS Code result in an equivalent single amortization period that is longer than the maximum allowable 30 year period specified by GASB 25. The GASB 25 amortization payment will be set equal to the level dollar amount that will amortize the unfunded accrued liability over a period equal to the maximum allowable period specified by GASB 25.

(b) Asset Valuation Method

For actuarial purposes, assets are valued using a five-year moving market average value that will recognize the 8.00% 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 (as required by Act 2002-38). 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.

(c) Actuarial Assumptions

Significant actuarial assumptions employed by the actuary for funding purposes as of June 30, 2009, the date of the most recent actuarial valuation include:

- Investment return – 8.00%, includes inflation at 3.25%
- Salary increases – 6.00%, which reflects an allowance for inflation of 3.25%, real wage growth of 1%, and merit or seniority increases of 1.75%
- Amortization method – level dollar funding
- 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 Annuity Reserve Account with interest credited thereon at an annual rate of 5.50% is compared to

Notes to Financial Statements (continued)

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.

(C) Postemployment Healthcare Plans

i. Health Insurance Premium Assistance Program

(a) Premium Assistance Benefits

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

(b) Funding Status and Annual Required Contributions

As of June 30, 2009, the most recent actuarial valuation, the plan was 9.1% funded. The actuarial accrued liability for benefits was $1.2 billion, and the actuarial value of assets was $105.1 million, resulting in an unfunded accrued liability of $1.1 billion. The covered payroll of active members was $12.5 billion and the ratio of the unfunded actuarial accrued liability to the covered payroll was 8.4%.

For fiscal year ended June 30, 2010, the ARC was $117.2 million. The actual employer contributions for fiscal year ended June 30, 2010 was $102.7 million resulting in an 88% contributed rate.

The Schedule of Funding Progress and Schedule of Employer Contributions included as Required Supplemental Information following the notes to the financial statements provide multiyear 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 account, and the contribution required is the amount necessary to establish reserves sufficient to provide PA 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 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. 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.

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.

Notes to Financial Statements (continued)

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 43,000 participants in the PDP. An independent 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, 2010 and 2009 PSERS recorded $10,107,000 and $10,423,000, 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 security 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 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.

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, 2010 and 2009, $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, 2012. The line is payable at an interest rate equivalent to the lender's commercial paper rate plus 100 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 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 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.

Notes to Financial Statements (continued)

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 seven 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, 2010 and 2009, $3,324,000 and $3,222,000, 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, 2010 and 2009 are for HOP premiums related to health care coverage to be provided in calendar year 2010 and 2009, 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.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) provided for periodic increases in the annual compensation limits for qualified retirement plans. The annual compensation limit for 2009 and 2010 was $245,000. EGTRRA also provided for periodic increases in the annual benefit limits for qualified defined benefit plans. The maximum annual defined benefit limit at age 62 for 2009 and 2010 was $195,000.

The Pension Protection Act of 2006 allows distributions for a deceased member to be rolled over by a nonspouse beneficiary. The direct trustee-to-trustee transfer is an eligible rollover distribution and is made to an IRA that is treated as an inherited account.

(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 2009 amounts have been reclassified in conformity with the 2010 presentation.

(J) Members Receivables

Members receivables include an amount for members' obligations to the System for the purchase of service credit of $157,747,000 and $164,892,000 at June 30, 2010 and

Notes to Financial Statements (continued)

2009, respectively. 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 purchase of service receivables extend beyond one year. An estimated $110,162,000 of the $240,569,000 members pension receivables at June 30, 2010 are expected to be collected by the System subsequent to June 30, 2011. At June 30, 2009, an estimated $144,278,000 of the $244,327,000 members pension receivables were expected to be collected by the System subsequent to June 30, 2010.

(K) Adoption of New Accounting Standards

In June 2007 the Governmental Accounting Standards Board issued Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. GASB 51 states that intangible assets are subject to all the accounting and financial reporting requirements applicable to other types of capital assets. GASB 51 also offers specialized guidance on certain unique aspects of accounting and financial reporting for intangibles. The System adopted this Statement during the year ended June 30, 2010.

During the year ended June 30, 2010 the System adopted GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. GASB 53 was issued to address the recognition, measurement, and disclosure of information regarding derivative instruments entered into by state and local governments.

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)	
	2010	**2009**
Pension:		
State Accumulation Account	**$ (4,732,711)**	$ (5,608,486)
Members' Savings Account	**11,850,031**	11,087,345
Annuity Reserve Account	**38,481,155**	37,516,621
	$ 45,598,475	$ 42,995,480
Postemployment healthcare:		
Health Insurance Account	**$ 116,831**	$ 105,114
Health Insurance Program Account	**122,221**	106,446
	$ 239,052	$ 211,560

(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 8.00% 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.

(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

Notes to Financial Statements (continued)

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. 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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Notes to Financial Statements (continued)

A summary of the fair value of investments at June 30, 2010 and 2009 follows:

	(Dollar Amounts in Thousands) 2010	2009
Pension investments:		
Short-term:		
PSERS Short-Term Investment Fund	**$ 3,171,190**	$ 4,253,396
Other domestic short-term	**544,374**	706,544
International short-term	**225,667**	244,478
	3,941,231	5,204,418
Fixed income:		
Domestic mortgage-backed securities	**3,432,285**	3,740,617
U.S. government and agency obligations	**1,619,970**	1,416,505
Domestic corporate and taxable municipal bonds	**2,073,324**	2,271,173
Miscellaneous domestic fixed income	**343,884**	456,144
Collective trust funds	**3,227,846**	2,529,667
International fixed income	**1,175,893**	919,443
	11,873,202	11,333,549
Common and preferred stock:		
Domestic common and preferred stock	**5,247,040**	3,073,854
Collective trust funds	**4,486,879**	3,929,724
International common and preferred stock	**5,583,038**	6,879,794
	15,316,957	13,883,372
Real estate:		
Equity real estate	**3,780,406**	3,493,360
Directly-owned real estate	**193,467**	205,993
	3,973,873	3,699,353
Alternative investments:		
Private equity	**6,130,796**	5,047,201
Private debt	**4,277,438**	3,283,060
Venture capital	**768,487**	698,671
	11,176,721	9,028,932
Pension investments at fair value	**$ 46,281,984**	$ 43,149,624
Postemployment healthcare investments:		
Premium Assistance:		
PSERS Short-Term Investment Fund	**$ 24,908**	$ 27,063
Other domestic short-term	**54,940**	40,205
	79,848	67,268
Health Options Program:		
PSERS Short-Term Investment Fund	**85,141**	84,683
Other domestic short-term	**57,295**	42,360
	142,436	127,043
Postemployment healthcare investments at fair value	**$ 222,284**	$ 194,311

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 $57,295,000 and $42,360,000 at June 30, 2010 and 2009, 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, 2010 and 2009 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 27.9% of the investment portfolio. The fixed income target allocation consists of:

- An allocation of 5.0% of the portfolio has been made to the domestic core plus segment of the fixed income asset class benchmarked to the Barclays Capital U.S. Universal Index. The domestic 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 8.0% of the portfolio has been made to the high yield and opportunistic segment of the fixed income asset class benchmarked to the Barclays Capital U.S. High Yield Index. The high yield and opportunistic 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% 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.

Notes to Financial Statements (continued)

The portfolio manager is permitted to leverage the portfolio using TIPS total return swaps up to 3:1.

- An allocation of 2.0% of the portfolio has been made to the global core plus fixed income asset class benchmarked to the Barclays Capital Multiverse 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.

- An allocation of 2.9% of the portfolio has been made to the emerging markets fixed income asset class benchmarked to the JP Morgan GBI-EM Global Diversified (USD Unhedged) 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% 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 A+ 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, 2010 and 2009.

	(Dollar Amounts in Thousands)	
	2010	2009
Quality Rating	**Fair Value**	Fair Value
AAA	**$ 3,347,321**	$ 4,434,124
AA	**3,891,933**	5,037,592
A	**844,840**	888,204
BBB	**860,078**	812,151
BB and below	**1,153,604**	895,804
NR*	**3,981,288**	3,068,343
Total Exposed to Credit Risk	**14,079,064**	15,136,218
US Government Guaranteed**	**1,957,653**	1,596,060
Total Fixed Income and Short-Term Investments	**$ 16,036,717**	$ 16,732,278

* Not Rated securities include $3,227,846 and $2,529,667 in collective trust funds at June 30, 2010 and 2009, 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, 2010 and 2009.

	(Dollar Amounts in Thousands)	
	2010	2009
Quality Rating	**Fair Value**	Fair Value
AA	**$ 2,176**	$ (12,577)
A	**(197,715)**	55,355
Total Swaps-Total Return	**$ (195,539)**	$ 42,778

(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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Notes to Financial Statements (continued)

At June 30, 2010 and 2009, the System's fixed income portfolio had the following option-adjusted durations by fixed income sector:

	(Dollar Amounts in Thousands)			
	2010		2009	
Investment Type	**Option-Adjusted Duration**	**Fair Value**	Option-Adjusted Duration	Fair Value
Domestic mortgage-backed securities	**1.2**	**$ 3,432,285**	1.7	$ 3,740,617
U.S. government and agency obligations	**5.1**	**1,619,970**	3.6	1,416,505
Domestic corporate and taxable municipal bonds	**3.3**	**2,073,324**	3.0	2,271,173
Miscellaneous domestic fixed income	**0.4**	**343,884**	0.4	456,144
Fixed income collective trust funds	**4.6**	**3,227,846**	4.3	2,529,667
International fixed income	**4.0**	**1,175,893**	3.8	919,443
PSERS Short-Term Investment Fund	**0.1**	**3,281,239**	0.1	4,365,142
Total fixed income & Short-Term Investment Funds	**2.6***	**15,154,441**	2.1*	15,698,691
Total adjustments for futures contracts	**0.1****	**-**	0.1**	-
Total fixed income & Short-Term Investment Funds	**2.7****	**$ 15,154,441**	2.2**	$ 15,698,691

* The option-adjusted duration of 2.6 and 2.1 at June 30, 2010 and 2009, respectively, for the total fixed income and Short-Term Investment Funds 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 and Short-Term Investment Funds duration upward by 0.1 at June 30, 2010 and 2009.

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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, 2010 and 2009 PSERS had the following non-U.S. currency exposure:

2010
(Dollar Amounts in Thousands)

Currency	Equity	Fixed Income	Alternative Investments & Real Estate	Short-Term*	Total Fair Value
Euro	$ 718,560	$ 225,174	$ 1,569,466	$ (1,062,424)	**$ 1,450,776**
Japanese yen	1,002,241	44,154	-	265,647	**1,312,042**
British pound sterling	925,069	27,859	6,361	(255,052)	**704,237**
Canadian dollar	449,599	28,858	1,635	(15,744)	**464,348**
Brazil real	106,741	48,410	-	203,926	**359,077**
Hong Kong dollar	331,705	-	-	2,235	**333,940**
Australian dollar	319,224	3,230	-	(28,455)	**293,999**
South African rand	124,363	20,119	-	143,848	**288,330**
Indonesian rupian	51,497	26,481	-	171,451	**249,429**
Turkish lira	40,351	21,626	-	143,646	**205,623**
Indian rupee	113,637	-	-	76,055	**189,692**
Mexican new peso	34,856	45,167	-	79,731	**159,754**
Other non-US currencies	964,616	121,486	-	(649,128)	**436,974**
Total	$ 5,182,459	$ 612,564	$ 1,577,462	$ (924,264)	**$ 6,448,221**

2009
(Dollar Amounts in Thousands)

Currency	Equity	Fixed Income	Alternative Investments & Real Estate	Short-Term*	Total Fair Value
Euro	$ 1,047,301	$ 269,565	$ 1,247,221	$ 92,495	**$ 2,656,582**
Japanese yen	1,254,289	55,862	-	182,435	**1,492,586**
British pound sterling	1,078,529	31,998	6,776	86,898	**1,204,201**
Hong Kong dollar	566,206	-	-	2,429	**568,635**
Australian dollar	347,456	1,879	-	44,524	**393,859**
Swiss franc	378,039	-	-	(3,390)	**374,649**
Canadian dollar	407,085	2,761	4,304	(41,540)	**372,610**
South African rand	167,544	-	-	51,311	**218,855**
Brazil real	124,471	17,867	-	25,069	**167,407**
Indian rupee	109,516	314	-	44,161	**153,991**
Other non-US currencies	886,940	89,209	-	(63,368)	**912,781**
Total	$ 6,367,376	$ 469,455	$ 1,258,301	$ 421,024	**$ 8,516,156**

* Includes investment receivables and payables

Notes to Financial Statements (continued)

Currency	2010 Notional Value	2009 Notional Value
	(Dollar Amounts in Thousands)	
Japanese yen	**$ 107,111**	$ 163,061
British pound sterling	**72,823**	154,480
Canadian dollar	**27,023**	25,750
Euro	**23,146**	172,934
Australian dollar	**17,839**	24,077
Malaysian ringgit	**1,099**	-
Total Futures Contracts and Total Return Swaps	**$ 249,041**	$ 540,302

At June 30, 2010 and 2009, 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, 2010 and 2009, 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, 2010 and 2009, 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, 2010 and 2009.

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 and 15 days at June 30, 2010 and 2009, respectively. During the fiscal years ended June 30, 2010 and 2009, 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.

During the fiscal year ended June 30, 2009, certain securities purchased with cash collateral by the lending agent declined significantly in value, resulting in a net loss to the System from the securities lending program. The System acquired new securities for the collateral pool during the fiscal year ended June 30, 2009 to replace the value lost on the securities that had been purchased by the lending agent. As of June 30, 2010, the fair value of loaned securities was $2,102,233,000, which includes $636,236,000 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 $2,239,674,000 of which $1,524,234,000 was cash. As of June 30, 2009, the fair value of loaned securities was $2,109,420,000, which includes $584,108,000 of loaned securities which are collateralized by securities and irrevocable letters of credit that are not included in the Statements of Plan

Notes to Financial Statements (continued)

Net Assets. The fair value of the associated collateral was $2,232,432,000 of which $1,591,720,000 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; 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. The table presented at the bottom of the page summarizes the aggregate notional or contractual amounts for the System's derivative financial instruments at June 30, 2010 and 2009.

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	(Dollar Amounts in Thousands)	
	2010	2009
Futures contracts – long:		
Treasury futures	**$ 400,302**	$ 460,044
Eurodollar futures	**83,922**	245,141
U.S. equity futures	**424,961**	1,214,777
Non-U.S. equity futures	**154,454**	199,432
Commodity futures	**1,015,632**	1,036,767
Non-U.S. bond futures	**69,060**	154,103
Futures contracts – short:		
Treasury futures	**294,089**	304,684
Eurodollar futures	**263,378**	426,875
U.S. equity futures	**-**	985,490
Commodity futures	**21,659**	51,020
Non-U.S. bond futures	**40,038**	38,411
Foreign exchange forward and spot contracts, gross	**11,147,219**	6,266,360
Options - calls purchased	**2,555,244**	1,198,018
Options - puts purchased	**2,241,375**	766,916
Options - calls sold	**2,784,401**	972,583
Options - puts sold	**2,376,839**	827,220
Swaps - total return type	**3,950,185**	5,041,734

Notes to Financial Statements (continued)

(Dollar Amounts in Thousands)

	Change In Fair Value FY 2010		Fair Value at June 30, 2010	
Derivative Type	**Classification**	**(Gain)/Loss**	**Classification**	**Amount**
Futures	Investment income	$ 16,146	Investment	$ (16,146)
Total return type swaps	Investment income	195,539	Investment	(195,539)
Options	Investment income	(2,093)	Investment	2,093
Foreign exchange contracts	Investment income	4,414	Investment	(4,414)
	Change In Fair Value FY 2009		**Fair Value at June 30, 2009**	
Derivative Type	**Classification**	**(Gain)/Loss**	**Classification**	**Amount**
Futures	Investment income	$ (3,060)	Investment	$ 3,060
Total return type swaps	Investment income	(42,778)	Investment	42,778
Options	Investment income	(10,713)	Investment	10,713
Foreign exchange contracts	Investment income	10,398	Investment	(10,398)

The fair values of derivative instruments outstanding at June 30, 2010 and 2009 are classified by type and by the changes in fair value of the derivative instrument in the table as presented at the top of the page.

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, 2010 and 2009 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 $1,500,000,000. The fair value of option contracts of $2,093,000 and $10,713,000 at June 30, 2010 and 2009, 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 primarily include forwards. The $11,147,219,000 of foreign currency contracts outstanding at June 30, 2010 consist of “buy” contracts, which represent the U.S. dollar equivalents of commitments to purchase foreign currencies of $5,219,411,000 and “sell” contracts, which represent U.S. dollar equivalents of commitments to sell foreign currencies of $5,927,808,000. The $6,266,360,000 of foreign currency contracts outstanding at June 30, 2009 consist of “buy” contracts of $3,609,991,000 and “sell” contracts of $2,656,369,000. The unrealized loss on contracts of $(4,414,000) and $(10,398,000) at June 30, 2010 and 2009, respectively, is included in the Statements of Plan Net Assets and represents the fair value of the contracts.

Notes to Financial Statements (continued)

The following table summarizes the System's foreign exchange contracts by currency at June 30, 2010 and 2009:

2010 (Dollar Amounts in Thousands)				
Currency	**Buys**	**Unrealized Gain/(Loss)**	**Sells**	**Unrealized Gain/(Loss)**
British pound sterling	$ 586,528	$ (2,641)	$ 851,017	$ (5,525)
Euro	539,486	(2,917)	1,527,863	13,594
Swiss franc	511,100	13,794	678,377	(26,277)
Japanese yen	466,086	12,782	204,617	(5,852)
Brazil real	412,989	194	210,547	666
Australian dollar	405,024	(5,533)	368,986	3,188
Canadian dollar	233,343	(6,153)	234,936	4,381
Turkish lira	212,278	(2,691)	68,574	88
South African rand	200,943	(271)	58,571	(42)
Mexican new peso	199,108	(3,426)	120,167	56
Indian rupee	175,622	2,612	4,563	5
Norwegian krone	171,567	2	146,774	328
Swedish krona	157,145	1,490	171,665	(2,202)
New Zealand dollar	113,680	(419)	92,993	(154)
Philippines peso	92,357	(614)	26,114	(24)
South Korean won	91,801	(1,986)	162,813	5,823
Indonesian rupian	89,833	(162)	16,661	(51)
Malaysian ringgit	86,622	537	34,484	(609)
Other	473,899	(2,675)	948,086	6,270
Total	**$ 5,219,411**	**$ 1,923**	**$ 5,927,808**	**$ (6,337)**

2009 (Dollar Amounts in Thousands)				
Currency	**Buys**	**Unrealized Gain/(Loss)**	**Sells**	**Unrealized Gain/(Loss)**
Euro	$ 1,037,498	$ 13,252	$ 753,084	$ (17,902)
Japanese yen	778,940	(4,948)	534,881	(11,673)
British pound sterling	336,353	9,153	168,219	(2,059)
Australian dollar	248,663	4,874	127,844	(1,260)
Canadian dollar	103,477	(1,136)	137,900	2,092
South African rand	92,605	5,664	43,302	(2,938)
Swedish krona	83,837	(163)	111,030	(853)
Mexican new peso	83,909	480	42,875	(1,188)
Norwegian krone	71,057	(321)	64,825	414
Swiss franc	70,963	(348)	63,140	(559)
Hungarian forint	70,488	2,355	14,755	(632)
Danish krone	70,486	(1)	33,788	372
Brazil real	59,510	1,747	33,353	(596)
Chilean peso	52,109	1,571	10,416	(586)
Indonesian rupian	50,485	(276)	7,167	33
Philippines peso	44,518	(415)	42,472	(16)
Other	355,093	1,229	467,318	(5,764)
Total	**$ 3,609,991**	**$ 32,717**	**$ 2,656,369**	**$ (43,115)**

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, 2010 and 2009, 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 $(195,539,000) and $42,778,000 at June 30, 2010 and 2009, 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 31, 2010 to August 9, 2011.

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, 2010 and 2009 is $2,089,780,000 and $2,295,709,000, 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% 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 3.15% at June 30, 2010, 3.29% at June 30, 2009 and 3.28% at June 30, 2008. The System's contributions to SERS for the years ended June 30, 2010, 2009 and 2008 were $601,000, $625,000 and $602,000, 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 Administrative 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. The 2009-2010 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 October 2009, the Commonwealth released an Actuarial Valuation of its Post-Retirement Medical Plan with calculations made as of July 1, 2008 using census data collected as of December 2008 and health care claims costs for calendar 2008. The Valuation for FY 2009 reported overall Annual Required Contributions (ARC) of $818,510,000 with the System's allocated ARC of $3,566,000. Based on the aggregate REHP qualifying contributions for FY 2009, the net Other Postemployment Benefits (OPEB) liability for the System was $1,363,000. For FY 2010, the valuation indicated overall ARC of $850,440,000 with the System's allocated ARC of $3,705,000. Based on the aggregate REHP qualifying contributions for FY 2010, the net OPEB liability for the System is $1,460,000. Therefore, the cumulative 2 year total OPEB liability as of June 30, 2010 is $2,823,000. The Actuarial Valuation is available at the Office of the Budget's website: www.budget.state.pa.us.

Notes to Financial Statements (continued)

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. Intangible Assets

In compliance with the requirements of GASB 51, the System examined its administrative expense records to determine if any expenditure qualified for intangible asset recognition. It was found that the multi-year initiative to redesign the System's member and pension administration systems qualified for recognition as internally developed computer software under GASB 51 and Commonwealth of Pennsylvania Management Directives.

(A) Assumptions

In FY 2003, the System began contracting with third parties on a multi-year project to develop a new pension administration system (NPAS) using customized off-the-shelf computer software (V3). The System will continue to contractually rely on third parties to reengineer and upgrade V3 to meet PSERS business requirements. V3 software will have major upgrades over time and will have a finite expected useful life estimated at 20 years. The first release of NPAS was implemented during July 2004, which is the start of the useful life of V3 for amortization purposes.

(B) Recognition

From FY 2003 through the current FY 2010, it was determined that $23.8 million qualifies for recognition under GASB 51 as intangible assets. Amortization for fiscal years prior to FY 2010 was calculated starting in fiscal year ended June 30, 2005 (FY 2005) assuming an estimated useful life period of 20 years. Cumulative amortization through the end of FY 2010 totaled $5.7 million.

Recognition of intangible assets and amortization was made during FY 2010 by offset to administrative expenses.

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

Pension

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)
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%
2005	61,129.4	51,122.1	10,007.3	83.6%	10,527.7	95.1%
2004	56,978.1	51,949.6	5,028.5	91.2%	10,030.7	50.1%

Premium Assistance

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)
2009	$ 1,159.0	$ 105.1	$ 1,053.9	9.1%	$ 12,524.6	8.4%
2008	1,133.0	95.8	1,037.2	8.5%	11,921.5	8.7%
2007	1,058.1	97.3	960.8	9.2%	11,410.3	8.4%
2006	1,056.2	92.8	963.4	8.8%	11,419.0	8.4%

* The amounts reported 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.

Required Supplemental 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
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%
2006	1,328,373	456,878	34%
2005	945,107	431,556	46%

* Net of purchase of service contributions.

Premium Assistance

Year ended June 30	Annual Required Contributions	Actual Employer Contributions	Percentage Contributed
2010	$ 117,187	$ 102,703	88%
2009	109,531	92,493	84%
2008	101,352	81,317	80%
2007	94,970	86,763	91%

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.

Supplemental Schedule 1
Schedule of Operating Expenses
Year Ended June 30, 2010
(Dollar Amounts in Thousands)

	Administrative Expenses (1)	Investment Expenses (2)	Total
Personnel costs:			
Salaries & wages	$ 14,972	$ 3,393	**$ 18,365**
Social security contributions	1,136	251	**1,387**
Retirement contributions	462	139	**601**
Employees' insurance contributions	4,211	543	**4,754**
Other employee benefits	113	723	**836**
Total personnel costs	20,894	5,049	**25,943**
Operating costs:			
Investment managers' fees	-	509,767	**509,767**
Custodian fees	-	598	**598**
Specialized services	20,079	-	**20,079**
Rental of real estate, electricity	2,108	183	**2,291**
Consultant & legal fees	1,227	4,499	**5,726**
Treasury and other commonwealth services	1,265	162	**1,427**
Postage	1,052	-	**1,052**
Contracted maintenance and repair services	280	14	**294**
Office supplies	497	81	**578**
Rental of equipment & software	862	234	**1,096**
Printing	408	-	**408**
Travel and training	291	16	**307**
Telecommunications	601	14	**615**
Equipment (non-capital assets)	1,028	4	**1,032**
Miscellaneous expenses	2,809	1,694	**4,503**
Total operating costs	32,507	517,266	**549,773**
Other charges:			
Capitalized assets (3)	(23,849)	-	**(23,849)**
Depreciation (3)	940	-	**940**
Total other charges	(22,909)	-	**(22,909)**
Total operating expenses	$ 30,492	$ 522,315	**$ 552,807**

(1) Includes administrative expenses of $1,944 related to Postemployment Healthcare Premium Assistance and $16,443 related to Postemployment Healthcare Health Options Program for the fiscal year ended June 30, 2010.

(2) Includes investment expenses of $47 related to Postemployment Healthcare Premium Assistance for fiscal year ended June 30, 2010 and does not include $17,650 in capitalized broker commissions for the fiscal year ended June 30, 2010.

(3) Depreciation includes amortization of intangible assets. Capitalized assets and depreciation have been adjusted due to the impact of capitalization of intangible assets as a result of PSERS' implementation of Governmental Accounting Standards Board Statement No. 51 *Accounting and Financial Reporting for Intangible Assets* (See Note 9).

Supplemental Schedule 2
Summary of Investment Expenses
Year Ended June 30, 2010
(Dollar Amounts in Thousands)

		Assets under management*		Fees
External management:				
Domestic equity	$	858,000	$	5,284
International equity		3,307,000		32,162
Fixed income		7,281,000		58,355
Real estate		3,975,000		83,687
Alternative investments		9,362,000		178,183
Absolute return		5,196,000		137,360
Commodities		1,769,000		14,736
Total external management		**31,748,000**		**509,767**
Total internal management		**14,256,000**		**7,451**
Total investment management	**$**	**46,004,000**	**$**	**517,218**
Custodian fees				598
Consultant and legal fees				4,499
Total investment expenses			**$**	**522,315**

* Net asset value of investments at June 30, 2010; investments are classified on an asset allocation basis.

Supplemental Schedule 3
Schedule of Payments to Non-Investment Consultants
Year Ended June 30, 2010
(Dollar Amounts Greater than $50,000)

Consultant	Fees	Services Provided
CoreSource, Inc.	$ 11,018,949	Postemployment healthcare benefits administration and claims adjudication
ViTech Systems Group, Inc.	3,582,055	Pension administration system services
Rx Solutions, Inc.	2,816,847	Administration of postemployment healthcare benefits and prescription drug plan
The Segal Company	2,467,835	Actuarial services and consulting for HOP and prescription drug plan
Buck Consultants LLC	716,018	Pension benefit actuarial services
Independent Pharmaceutical Consultants, Inc.	378,275	Pharmacy benefit consulting services
Clifton Gunderson LLP	114,755	Financial audit of pension system and postemployment healthcare programs