

**ALASKA RETIREMENT MANAGEMENT BOARD**

**Military Retirement System**

**Invested Assets**

**June 30, 2007 and 2006**

**(With Independent Auditors' Report Thereon)**

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## **Independent Auditors' Report**

Alaska Retirement Management Board and  
State of Alaska, Department of Revenue  
Division of Treasury:

We have audited the accompanying schedules of invested assets of the Military Retirement System as of June 30, 2007 and 2006 and the schedules of investment income and changes in invested assets for the years then ended (schedules). These schedules are the responsibility of the Division of Treasury's management. Our responsibility is to express an opinion on these schedules 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 audits to obtain reasonable assurance about whether the schedules are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for expressing an opinion on internal control over financial reporting. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedules, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audits provide a reasonable basis for our opinion.

The accompanying schedules were prepared to present the invested assets of the Military Retirement System, which is established under the State of Alaska National Guard and Naval Militia Retirement System (NG & NMRS). The schedules are not intended to present the financial status of NG & NMRS.

In our opinion, the schedules referred to above present fairly, in all material respects, the invested assets of the Military Retirement System as of June 30, 2007 and 2006, and the investment income and changes in invested assets for the years then ended in conformity with U.S. generally accepted accounting principles.

**KPMG LLP**

October 2, 2007

## MILITARY RETIREMENT SYSTEM

### Schedules of Invested Assets

June 30, 2007 and 2006

	<u>2007</u>	<u>2006</u>
Investments (at fair value):		
Cash and cash equivalents:		
Short-term Fixed Income Pool	\$ 12,818	24,997
Securities Lending Collateral	<u>1,804,387</u>	<u>1,740,198</u>
Total cash and cash equivalents	<u>1,817,205</u>	<u>1,765,195</u>
Marketable debt securities:		
Domestic Fixed Income Pool	10,166,983	8,642,845
Equity securities:		
Domestic Equity Pool	5,303,340	4,971,107
International Equity Pool	<u>2,219,659</u>	<u>2,034,314</u>
Total equity securities	<u>7,522,999</u>	<u>7,005,421</u>
Total invested assets	19,507,187	17,413,461
Securities lending collateral	<u>1,804,387</u>	<u>1,740,198</u>
Total net assets	<u>\$ 17,702,800</u>	<u>15,673,263</u>

See accompanying notes to schedules

## MILITARY RETIREMENT SYSTEM

### Schedules of Investment Income and Changes in Invested Assets

Years ended June 30, 2007 and 2006

	<u>2007</u>	<u>2006</u>
Investment income:		
Short-term Fixed Income Pool	\$ 853	6,073
Securities Lending (net of \$98,512 and \$49,257 expense)	3,583	3,110
Domestic Fixed Income Pool	617,579	(15,742)
Domestic Equity Pool	1,018,405	412,552
International Equity Pool	578,554	508,086
Total investment income	2,218,974	914,079
Total invested assets, beginning of year	15,673,263	14,600,709
Net contributions (withdrawals)	(189,437)	158,475
Total invested assets, end of year	\$ <u>17,702,800</u>	<u>15,673,263</u>

See accompanying notes to schedules

# **Military Retirement System Invested Assets**

## **Notes to Schedules June 30, 2007 and 2006**

### **(1) THE ACCOUNTING ENTITY**

The Military Retirement System Invested Assets (MRS Invested Assets) is the investment portfolio of the State of Alaska National Guard and Naval Militia Retirement System (NG & NMRS). NG & NMRS is a single-employer defined benefit system established for the payment of retirement, disability and death benefits to, or on behalf of, qualified members of the Alaska National Guard, Alaska Naval Militia and Alaska Air Guard. These Schedules are those of MRS Invested Assets and not NG & NMRS taken as a whole. Fiduciary responsibility for MRS Invested Assets resides with the Alaska Retirement Management Board (Board), pursuant to Alaska Statutes 37.10.210-390.

Alaska Statutes 14.25.180, 26.05.228(c) and 37.10.071 provide that investments shall be made with the judgment and care under circumstances then prevailing that an institutional investor of ordinary professional prudence, discretion and intelligence exercises in managing large investment portfolios.

The Department of Revenue, Treasury Division (Treasury) provides staff for the Board. Treasury has created a pooled environment by which it manages the investments the Board has fiduciary responsibility for. Actual investing is performed by investment officers in Treasury or by contracted external investment managers. The Board has developed investment guidelines, policies and procedures for Treasury staff and external investment managers to adhere to when managing investments. Specifically, the Securities Lending Collateral, External Domestic Fixed Income Pool, Domestic Equity Pool and the International Equity Pool are managed by external management companies. Treasury manages the Alaska Retirement Fixed Income Pool and cash holdings of certain external domestic equity managers in addition to acting as oversight manager for all externally managed investments.

The Short-term Fixed Income Pool is a State pool managed by Treasury.

### **(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

#### **Basis of Accounting**

The schedules are prepared using the accrual basis of accounting for investment income. Assets are reported at fair value. Investment purchases and sales are recorded on a trade-date basis. Net withdrawals represent contributions from employers and employees, net of benefits paid to NG & NMRS participants as well as administrative and investment management expenses. Contributions, benefits paid and all expenses are recorded on a cash basis.

#### **Valuation**

Fixed income securities are valued each business day using prices obtained from a pricing service when such prices are available; otherwise, such securities are valued at the most current sale price or based on a valuation provided by investment managers.

Domestic and international equity securities are valued each business day using prices obtained from a pricing service or prices quoted by one or more independent brokers.

Securities expressed in terms of foreign currencies are translated into U.S. dollars at the prevailing exchange rates. Forward currency contracts are valued at the mid-point of representative quoted bid and asked prices.

# **Military Retirement System Invested Assets**

## **Notes to Schedules June 30, 2007 and 2006**

### **(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONT.)**

#### **Income Allocation**

Income in the fixed income and domestic and international equity pools is allocated to pool participants daily on a pro rata basis.

### **(3) POOLED INVESTMENTS**

#### **Short-term Fixed Income Pool**

MRS Invested Assets include participation in the State's internally managed Short-term Fixed Income Pool which was established March 15, 1993, with a start up and maintained share price of \$1. Treasury staff determines the allocation between permissible securities. Each participant owns shares in the pool, the number of which fluctuates daily with contributions and withdrawals. Participant shares also change at the beginning of each month when income is paid. At June 30, 2007 and 2006, MRS Invested Assets included a 0.0003% direct ownership in the Short-term Fixed Income Pool which included interest receivable of \$68 and \$71, respectively. MRS Invested Assets included a 0.044% and 0.04% indirect ownership in the Short-term Fixed Income Pool at June 30, 2007 and 2006, respectively.

#### **Enhanced Cash Fixed Income Pool**

MRS Invested Assets include participation in the State's internally managed Enhanced Cash Fixed Income Pool which was established in June 2007 with a startup and maintained share price of \$1,000. Treasury The share price at June 30, 2007 was \$1,000. Treasury staff determines the allocation between permissible securities. Each participant owns shares in the pool, the number of which fluctuates daily with contributions and withdrawals. Participant shares also change at the beginning of each month when income is paid. At year end only one pool, the Retirement Fixed Income Pool, was invested in the Enhanced Cash Fixed Income Pool. At June 30, 2007 MRS Invested Assets included a 0.40% direct ownership in the Enhanced Cash Fixed Income Pool.

#### **Domestic Fixed Income Pool**

MRS Invested Assets include participation in the Board's internally managed Domestic Fixed Income Pool which was established March 1, 1996, with a start up share price of \$1,000. The share price at June 30, 2007, was \$1,958. Treasury staff determines the allocation between permissible securities. Ownership in the pool is based on the number of shares held by each participant. The net asset value per share is determined by dividing the total fair value of the net assets of the pool by the number of shares of the pool outstanding on the valuation date. Contributions to and withdrawals from the pool are based on the beginning of the day net asset value per share on the day of the transaction. At June 30, 2007 and 2006, MRS Invested Assets included a 0.40% and 0.30% ownership in the Retirement Fixed Income Pool, respectively.

# **Military Retirement System Invested Assets**

## **Notes to Schedules June 30, 2007 and 2006**

### **(3) POOLED INVESTMENTS (CONT.)**

#### **Domestic Equity Pool**

The Domestic Equity Pool is comprised of an External Large Cap Domestic Equity Pool and an External Small Cap Domestic Equity Pool.

#### **Large Cap Domestic Equity Pool**

MRS Invested Assets include participation in the Board's externally managed Large Cap Domestic Equity Pool which was established July 1, 2004, with a start up share price of \$1,000. The share price at June 30, 2007, was \$1,368. Each manager independently determines the allocation between permissible securities. Ownership in the pool is based on the number of shares held by each participant. The net asset value per share is determined by dividing the total fair value of the net assets of the pool by the number of shares of the pool outstanding on the valuation date. Contributions to and withdrawals from the pool are based on the beginning of the day net asset value per share on the day of the transaction. At June 30, 2007 and 2006, MRS Invested Assets included a 0.09% and 0.09% ownership in the Large Cap Domestic Equity Pool, respectively.

#### **Small Cap Domestic Equity Pool**

MRS Invested Assets include participation in the Board's externally managed Small Cap Domestic Equity Pool which was established July 1, 2004, with a start up share price of \$1,000. The share price at June 30, 2007, was \$1,375. Each manager independently determines the allocation between permissible securities. Ownership in the pool is based on the number of shares held by each participant. The net asset value per share is determined by dividing the total fair value of the net assets of the pool by the number of shares of the pool outstanding on the valuation date. Contributions to and withdrawals from the pool are based on the beginning of the day net asset value per share on the day of the transaction. At June 30, 2007 and 2006, MRS Invested Assets included a 0.08% ownership in the Small Cap Domestic Equity Pool.

#### **International Equity Pool**

MRS Invested Assets include participation in the Board's externally managed International Equity Pool which was established January 1, 1992, with a start up share price of \$1,000. The share price at June 30, 2007, was \$4,302. Each manager independently determines the allocation between permissible securities. Ownership in the pool is based on the number of shares held by each participant. The net asset value per share is determined by dividing the total fair value of the net assets of the pool by the number of shares of the pool outstanding on the valuation date. Contributions to and withdrawals from the pool are based on the beginning of the day net asset value per share on the day of the transaction. At June 30, 2007 and 2006, MRS Invested Assets included a 0.08% and 0.10% ownership in the International Equity Pool, respectively.



# Military Retirement System Invested Assets

## Notes to Schedules June 30, 2007 and 2006

### (4) DEPOSITS AND INVESTMENT RISK

At June 30, 2007, MRS Invested Assets included the following:

	Fair value (in thousands)				
	Fixed income pools				Total
	Short-term	Enhanced cash	Domestic	Other	
Deposits	\$ —	—	—	58	58
Overnight Sweep Account (Imcs)	10	—	—	—	10
Money Market Fund (sl)	—	—	—	1,804	1,804
Short-term Investment Fund	66	—	—	—	66
Commercial Paper	146	—	12	—	158
U. S. Treasury Bills	—	—	—	5	5
U. S. Treasury Notes	—	—	1,106	—	1,106
U. S. Treasury Strips	—	—	1	—	1
U. S. Treasury Bonds	—	—	496	—	496
U.S. Government Agency Discount Notes	—	—	693	—	693
U.S. Government Agency Municipal Bonds	—	—	4	—	4
Municipal Bonds	—	—	7	—	7
Mortgage-backed	112	—	5,712	—	5,824
Other Asset-backed	810	7	651	—	1,468
Corporate Bonds	420	9	1,834	—	2,263
Yankees:					
Government	—	—	57	—	57
Corporate	89	—	204	—	293
Domestic Equity Pool:					
Limited Partnership Equity	—	—	—	444	444
Equity	—	—	—	4,777	4,777
International Equity Pool:					
Equity	—	—	—	2,157	2,157
Net Other Assets (Liabilities)	(7)	(3)	(2,182)	8	(2,184)
Other Pool Ownership	(1,633)	(13)	1,572	74	—
Total Invested Assets	\$ 13	—	10,167	9,327	19,507

# Military Retirement System Invested Assets

## Notes to Schedules June 30, 2007 and 2006

### (4) DEPOSITS AND INVESTMENT RISK, (CONT.)

At June 30, 2006, MRS Invested Assets included the following:

	Fair Value (in thousands)			
	Fixed Income Pools			Total
	Short-term	Domestic	Other	
Deposits	\$ -	\$ -	\$ 5	\$ 5
Overnight Sweep Account	2	3	-	4
Money Market Fund	-	-	1,740	1,740
Short-term Investment Fund	44	-	31	74
Commercial Paper	87	25	-	112
U. S. Treasury Bills	-	-	-	-
U. S. Treasury Notes	-	460	-	460
U. S. Treasury Bonds	-	504	-	504
U. S. Treasury Strips	-	43	-	43
U.S. Government Agency Discount Notes	-	358	-	358
U.S. Government Agency Municipal Bonds	-	775	-	775
Municipal Bonds	-	5	-	5
Mortgage-backed	75	4,127	-	4,202
Other Asset-backed	522	472	-	993
Corporate Bonds	270	1,819	-	2,089
Yankees:				
Government	-	65	-	65
Corporate	11	5	-	16
Domestic Equity Pool:				
Limited Partnership	-	-	287	287
Equity	-	-	4,630	4,630
International Equity Pool:				
Equity	-	-	2,003	2,003
Net Other Assets (Liabilities)	(1 )	(959 )	6	(953 )
Other Pool Ownership	(985 )	941	43	-
Total Invested Assets	\$ 25	\$ 8,643	\$ 8,745	\$ 17,413

# **Military Retirement System Invested Assets**

## **Notes to Schedules June 30, 2007 and 2006**

### **(4) DEPOSITS AND INVESTMENT RISK, (CONT.)**

#### **Interest Rate Risk**

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment.

#### **Short-term Fixed Income Pool**

As a means of limiting its exposure to fair value losses arising from increasing interest rates, Treasury's investment policy limits individual fixed rate securities to fourteen months in maturity or fourteen months expected average life. Floating rate securities are limited to three years in maturity or three years expected average life. Treasury utilizes the actual maturity date for commercial paper and twelve-month prepay speeds for other securities. At June 30, 2007, the expected average life of individual fixed rate securities ranged from four days to seven months and the expected average life of floating rate securities ranged from less than one year to three years.

#### **Domestic Fixed Income Pool**

Through the Board's investment policy, Treasury manages the exposure to fair value losses arising from increasing interest rates by limiting the effective duration of the domestic fixed income portfolio to  $\pm 20\%$  of the Lehman Brothers Aggregate Bond Index. The effective duration for the Lehman Brothers Aggregate Bond Index at June 30, 2007, was 4.70 years.

Duration is a measure of interest rate risk. It measures a security's sensitivity to a 100-basis point change in interest rates. The duration of a pool is the average fair value weighted duration of each security in the pool taking into account all related cash flows.

Treasury uses industry-standard analytical software developed by The Yield Book Inc. to calculate effective duration. The software takes into account various possible future interest rates, historical and estimated prepayment rates, options and other variable cash flows for purposes of the effective duration calculation.

## Military Retirement System Invested Assets

### Notes to Schedules June 30, 2007 and 2006

#### (4) DEPOSIT AND INVESTMENT RISK (CONT.)

##### Interest Rate Risk (Cont.)

At June 30, 2007, the effective duration of the enhanced cash and domestic fixed income portfolios, by investment type, was as follows (in years):

	<u>Effective duration</u>	
	<u>Enhanced cash</u>	<u>Domestic</u>
U.S. Treasury notes	—	4.07
U.S. Government agency	—	4.52
Municipal bonds	—	12.33
Mortgage-backed	—	4.26
Other asset-backed	1.84	4.82
Corporate bonds	0.22	5.36
Yankees:		
Government	—	6.46
Corporate	—	11.03
Portfolio effective duration	0.08	3.99

##### Credit Risk

Credit risk is the risk that an issuer or other counter party to an investment will not fulfill its obligations.

Treasury's investment policy has the following limitations with regard to credit risk:

With the exception of the sweep account, Short-term Fixed Income Pool investments are limited to instruments with a long-term credit rating of at least A3 or equivalent and instruments with a short-term credit rating of at least A1 or equivalent. For securities with long-term credit ratings, they may be purchased if the median rating of Standard & Poor's Corporation, Moody's and Fitch is A3 or equivalent. Asset-backed and non-agency mortgage securities may be purchased if only rated by one of the rating agencies mentioned above if they are rated AAA. Unexpected daily cash surpluses that arise in this pool are invested overnight in the custodian's repurchase agreement sweep account. Treasury does not have a policy to limit credit risk associated with the sweep account.

## **Military Retirement System Invested Assets**

### **Notes to Schedules June 30, 2007 and 2006**

#### **(4) DEPOSIT AND INVESTMENT RISK (CONT.)**

##### **Credit Risk (Cont.)**

The Board's investment policy has the following limitations with regard to credit risk:

##### **Domestic Fixed Income:**

Commercial paper must carry a rating of at least A1 or equivalent; Corporate debt securities must be investment grade; Corporate, asset-backed and non-agency mortgage securities must be investment grade. Investment grade is defined as the median rating of Standard & Poor's Corporation, Moody's and Fitch. Asset-backed and non-agency mortgage securities may be purchased if only rated by one of these agencies if they are rated AAA. Corporate bonds may be purchased if rated by two of these agencies.

##### **Domestic and International Equity:**

Corporate debt obligations must carry a rating of at least A or equivalent.

## Military Retirement System Invested Assets

### Notes to Schedules June 30, 2007 and 2006

#### (4) DEPOSIT AND INVESTMENT RISK (CONT.)

At June 30, 2007, MRS Invested Assets consisted of securities with credit quality ratings issued by nationally recognized statistical rating organizations as follows (using Standard & Poor's Corporation rating scale):

	Rating <sup>1</sup>	Defined Benefit			
		Internally Managed Fixed Income Pools			
		Short-term	Cash	Domestic	International
Overnight Sweep Account	Not Rated	0.61%	-	-	-
Short-term Investment					
Account	Not Rated	3.96	-	-	0.36
Commercial Paper	AA	1.88	-	-	-
Commercial Paper	A	3.09	-	-	-
Commercial Paper	Not Rated	3.86	-	0.14	-
U. S. Government Agency					
Discount Notes	Not Rated	-	-	8.07	-
U. S. Government Agency	Not Rated	-	-	0.05	-
Mortgage-backed	AAA	6.50	-	51.10	-
Mortgage-backed	A	0.32	-	-	-
Mortgage-backed (Agency)	Not Rated	-	-	15.36	-
Other Asset-backed	AAA	40.98	2.65	5.14	-
Other Asset-backed	AA	0.91	-	0.27	-
Other Asset-backed	A	6.34	-	0.09	-
Other Asset-backed	BBB	-	1.00	0.74	-
Other Asset-backed	BB	-	-	-	-
Other Asset-backed	Not Rated	0.78	-	1.34	-
Municipal Bonds	AA	-	-	0.08	-
Corporate Bonds	AAA	1.97	-	1.89	25.92
Corporate Bonds	AA	15.13	0.60	4.28	11.43
Corporate Bonds	A	8.31	3.46	6.98	-
Corporate Bonds	BBB	-	1.04	7.15	-
Corporate Bonds	Not Rated	-	-	1.03	0.28
Yankees:					
Government	AAA - BBB	-	-	0.66	56.57
Government	Not Rated	-	-	-	3.83
Corporate	AA	3.09	-	-	-
Corporate	A	1.75	-	1.47	-
Corporate	BBB	-	-	0.61	-
Corporate	Not Rated	0.52	-	0.30	-
No credit exposure		-	91.25	(6.75)	1.61
		<u>100.00%</u>	<u>100.00%</u>	<u>100.00%</u>	<u>100.00%</u>

<sup>1</sup>Rating modifiers are not disclosed.

Securities lending collateral was invested in a registered 2(a)-7 money market fund that was not rated.

# Military Retirement System Invested Assets

## Notes to Schedules June 30, 2007 and 2006

### (4) DEPOSIT AND INVESTMENT RISK (CONT.)

#### Custodial Credit Risk – Deposits

Custodial credit risk is the risk that deposits may not be returned in the event of a bank failure. The Board does not have a policy in relation to custodial credit risk for deposits. At June 30, 2007, MRS Invested Assets had the following uncollateralized and uninsured deposits:

	<u>Amount</u> <u>(in thousands)</u>
International Equity Pool	\$ 4

#### Foreign Currency Risk

Foreign Currency Risk is the risk that changes in exchange rates will adversely impact the fair value of an investment.

The Board's policy with regard to foreign currency risk in the International Equity Pool is to permit MRS to hold up to fifteen percent of total investments in international equity.

At June 30, 2007, MRS investment in the International Equity Pool had exposure to foreign currency risk with the following deposits:

<u>Currency</u>	<u>Amount</u> <u>(in thousands)</u>
Australian Dollar	\$ 424
Canadian Dollar	3
Euro Currency	(1,161)
Hong Kong Dollar	542
Japanese Yen	2,889
New Zealand Dollar	9
Norwegian Krone	140
Pound Sterling	1,489
Singapore Dollar	1
Swedish Krona	81
Swiss Franc	2
	<u>\$ 4,419</u>

## Military Retirement System Invested Assets

### Notes to Schedules June 30, 2007 and 2006

#### (4) DEPOSIT AND INVESTMENT RISK (CONT.)

##### Foreign Currency Risk (Cont.)

At June 30, 2007, MRS investment in the International Equity Pool had exposure to foreign currency risk with the following investments:

Currency	Amount (in thousands) Equity
Australian Dollar	\$ 48
Canadian Dollar	43
Danish Krone	2
Euro Currency	807
Hong Kong Dollar	31
Japanese Yen	436
New Taiwan Dollar	8
New Zealand Dollar	9
Norwegian Krone	17
Pound Sterling	401
Singapore Dollar	22
South African Rand	2
South Korean Won	32
Swedish Krona	38
Swiss Franc	135
	\$ 2,031

##### Concentration of Credit Risk

Treasury's policy with regard to concentration of credit risk for the Short-term Fixed Income Pool is to prohibit the purchase of more than five percent of the portfolio's assets in corporate bonds of any one company or affiliated group.

The Board's policy with regard to concentration of credit risk for the Domestic Fixed Income Pool is to prohibit the purchase of more than five percent of the portfolio's assets in corporate bonds of any one company or affiliated group.

At June 30, 2007, MRS invested assets were not invested in any one issuer more than 5%.



## Military Retirement System Invested Assets

### Notes to Schedules June 30, 2007 and 2006

#### (5) FOREIGN EXCHANGE, FOREIGN EXCHANGE CONTRACTS AND OFF-BALANCE SHEET RISK

The International Equity Pool's investment income includes the following at June 30:

	<u>Amount (in thousands)</u>	
	<u>2007</u>	<u>2006</u>
Net realized gain (loss) on foreign currency	\$ 55,766	(29,519)
Net unrealized gain on foreign currency	40	141
Net realized gain on foreign exchange contracts	320	334

The International Equity Pool includes foreign currency forward contracts to buy and sell specified amounts of foreign currencies at specified rates on specified future dates for the purpose of hedging existing security positions. The maturity periods for these contracts range from eight to one hundred and twenty-four days. MRS had net unrealized gains (losses) with respect to such contracts, calculated using forward rates at June 30, as follows:

	<u>Amount (in thousands)</u>	
	<u>2007</u>	<u>2006</u>
Contract sales	\$ 1,748	3,912
Less fair value	<u>1,737</u>	<u>3,923</u>
Net unrealized gains on contracts	<u>\$ 11</u>	<u>(11)</u>

The counterparties to the foreign currency forward contracts consist of a diversified group of financial institutions. Credit risk exposure exists to the extent of non-performance by these counterparties; however, the risk of default is considered to be remote. The market risk is limited to the difference between contractual rates and forward rates at the balance sheet date.

#### (6) COMMITMENTS

The Board entered into an agreement through an external investment manager to provide capital funding for a domestic equity limited partnership. At June 30, 2007, MRS Invested Asset's share of the unfunded commitment totaled \$12,159. This commitment can be withdrawn annually in December with ninety days notice.

#### (7) SECURITIES LENDING

Alaska Statute 37.10.071 authorizes the Board to lend assets, under an agreement and for a fee, against deposited collateral of equivalent fair value. The Board has entered into an agreement with State Street Corporation (the Bank) to lend equity and domestic fixed income securities. The Bank, acting as the Board's agent under the agreement, transfers securities to broker agents or other entities for collateral in the form of cash or securities and simultaneously agrees to return the collateral for the same securities in the future.

At June 30, 2007 and 2006, the fair value of securities on loan allocable to MRS Invested Assets totaled \$1,845,930 and \$1,714,761, respectively. There is no limit to the amount that can be loaned and the Board is able to sell securities on loan. International equity security loans are collateralized at not less than 105 percent of their fair value. All other

## **Military Retirement System Invested Assets**

### **Notes to Schedules June 30, 2007 and 2006**

security loans are collateralized at not less than 102 percent of their fair value. Loaned securities and collateral is marked to market daily and collateral is received or delivered the following day to maintain collateral levels.

## **Military Retirement System Invested Assets**

### **Notes to Schedules June 30, 2007 and 2006**

#### **(7) SECURITIES LENDING (CONT.)**

Cash collateral of \$1,804,387 is invested in a registered 2(a)-7 money market fund. Maturities of investments in the money market fund generally did not match the maturities of the loaned securities because the lending agreements are terminable at will. Collateral securities in the amount of \$93,256 may be pledged or sold upon borrower default. Since the Board does not have the ability to pledge or sell collateral securities unless the borrower defaults, they are not recorded on the financial schedules. Securities under loan, cash collateral and cash collateral payable are recorded on the financial schedules at fair value. The Bank, MRS and the borrower receive a fee from earnings on invested collateral. The Bank and MRS share a fee paid by the borrower for loans not collateralized with cash.

There is limited credit risk associated with the lending transactions since the Board is indemnified by the Bank against any loss resulting from counterparty failure or default on a loaned security or its related income distributions. The Bank further indemnifies the Board against loss due to borrower rebates in excess of earnings on cash collateral. Indemnifications are subject to limitation relating to war, civil unrest or revolution, or beyond the reasonable control of the Bank.

For the year ended June 30, 2006 and 2007, there were no losses incurred as a result of securities lending transactions and there were no significant violations of legal or contractual provisions nor failures by any borrowers to return loaned securities.