



**STATE OF ALASKA
DEPARTMENT OF REVENUE
TREASURY DIVISION**

Military Retirement System

Invested Assets

Schedules

June 30, 2004 and 2003

(With Independent Auditors' Report Thereon)

**STATE OF ALASKA
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Independent Auditors' Report

Alaska State Pension Investment 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, 2004 and 2003 and of investment income (loss) and changes in invested assets of the Military Retirement System 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 audit to obtain reasonable assurance about whether the schedules are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedules. An audit also includes 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, 2004 and 2003, and the investment income (loss) and changes in invested assets for the years then ended in conformity with accounting principles generally accepted in the United States of America.

KPMG LLP

September 10, 2004

**STATE OF ALASKA
DEPARTMENT OF REVENUE
TREASURY DIVISION
MILITARY RETIREMENT SYSTEM**

SCHEDULES OF INVESTED ASSETS

June 30, 2004 and 2003

	<u>2004</u>	<u>2003</u>
Investments (at Fair Value) (Notes 4, 7)		
Cash and Cash Equivalents (Note 3)		
Short-term Fixed Income Pool	\$ <u>25,875</u>	\$ <u>26,527</u>
Marketable Debt Securities (Note 3)		
Retirement Fixed Income Pool	5,316,694	4,724,170
External Domestic Fixed Income Pool	<u>2,092,462</u>	<u>2,175,681</u>
Total Marketable Debt Securities	<u>7,409,156</u>	<u>6,899,851</u>
Equity Securities (Note 3)		
Domestic Equity Pool	4,348,896	4,529,491
International Equity Pool	<u>1,689,134</u>	<u>1,276,095</u>
Total Equity Securities	<u>6,038,030</u>	<u>5,805,586</u>
Total Invested Assets	\$ <u>13,473,061</u>	\$ <u>12,731,964</u>

See accompanying notes to schedules

**STATE OF ALASKA
DEPARTMENT OF REVENUE
TREASURY DIVISION
MILITARY RETIREMENT SYSTEM**

**SCHEDULES OF INVESTMENT INCOME (LOSS)
AND CHANGES IN INVESTED ASSETS**

Years ended June 30, 2004 and 2003

	<u>2004</u>	<u>2003</u>
Investment Income (Loss) (Note 5)		
Short-term Fixed Income Pool	\$ 511	\$ 1,328
Retirement Fixed Income Pool	72,775	505,146
External Domestic Fixed Income Pool	16,255	223,451
Domestic Equity Pool	751,478	119,955
International Equity Pool	<u>406,403</u>	<u>(78,625)</u>
Total Investment Income	1,247,422	771,255
Total Invested Assets, Beginning of Year	12,731,964	12,227,698
Net Withdrawals	<u>(506,325)</u>	<u>(266,989)</u>
Total Invested Assets, End of Year	<u>\$ 13,473,061</u>	<u>\$ 12,731,964</u>

See accompanying notes to schedules

Military Retirement System

Invested Assets

Notes to Schedules

June 30, 2004 and 2003

(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 State Pension Investment 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 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 in accordance with Governmental Accounting Standards Board (GASB) Statement No. 31. 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.

In fiscal year 2004, Governmental Accounting Standards Board (GASB) Statement No. 40, *Deposits and Investment Risk Disclosures* was implemented. GASB Statement No. 40 addresses disclosures on deposits and investments, focusing on common investment risks related to interest rate risk, credit risk, custodial credit risk, foreign currency risk and concentration of credit risk.

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 mid-point between the bid and asked price or at prices for securities of comparable maturity, quality and type.

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. Equity securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates or, in the absence of a sale, at the last reported bid price.

Military Retirement System Invested Assets

Notes to Schedules June 30, 2004 and 2003

(2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Valuation (Cont.)

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.

Income Allocation

Income, which includes interest and realized and unrealized gains and losses, in the fixed income pools is allocated to pool participants daily on a pro rata basis.

Income, which includes interest, dividends and realized and unrealized gains and losses, in the 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, 2004 and 2003, MRS Invested Assets included a 0.001% direct ownership in the Short-term Fixed Income Pool which included interest receivable of \$18 and \$24, respectively.

Retirement Fixed Income Pool

MRS Invested Assets include participation in the Board's internally managed Retirement Fixed Income Pool which was established March 1, 1996, with a start up share price of \$1,000. The share price at June 30, 2004 was \$1,723. 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, 2004 and 2003, MRS Invested Assets included a 0.24% and 0.22% ownership in the Retirement Fixed Income Pool, respectively.

External Domestic Fixed Income Pool

MRS Invested Assets include participation in the Board's externally managed Domestic Fixed Income Pool which was established June 25, 1999, with a start up share price of \$1,000. The share price at June 30, 2004 was \$1,448. 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, 2004 and 2003, MRS Invested Assets included a 0.19% ownership in the External Domestic Fixed Income Pool.

Military Retirement System Invested Assets

Notes to Schedules June 30, 2004 and 2003

(3) POOLED INVESTMENTS (Cont.)

Domestic Equity Pool

MRS Invested Assets include participation in the Board's externally managed Domestic Equity Pool which was established July 1, 1991, with a start up share price of \$1,000. The share price at June 30, 2004 was \$4,086. Each manager independently determines the allocation between equities and other 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, 2004 and 2003, MRS Invested Assets included a 0.09% and 0.10% ownership in the Domestic Equity Pool, respectively.

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, 2004 was \$2,312. Each manager independently determines the allocation between equities and other 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, 2004 and 2003, MRS Invested Assets included a 0.08% and 0.07% ownership in the International Equity Pool, respectively.

Military Retirement System Invested Assets

Notes to Schedules June 30, 2004 and 2003

(4) DEPOSITS AND INVESTMENT RISK

At June 30, 2004, MRS Invested Assets included the following (stated in thousands):

	Short-term Fixed Income Pool	Retirement Fixed Income Pool	External Domestic Fixed Income Pool	Equity	Total
Commercial Paper	\$ 356,409	\$ -	\$ -	\$ -	\$ 356,409
U.S. Treasury Notes	132,644	149,846	191,189	-	473,678
U.S. Treasury Bonds	-	120,358	55,410	-	175,767
U.S. Treasury Strips	-	31,210	5,264	-	36,474
U. S. Government Agency Discount Notes	-	-	210,132	-	210,132
U. S. Government Agency Mortgage-related	39,932	94,097	98,938	-	232,967
Asset-backed	154,138	1,081,936	463,823	-	1,699,897
Corporate	805,164	67,855	37,395	-	910,414
Yankees	466,513	525,012	213,034	-	1,204,559
Domestic Equity Pool:					
Convertible Bonds	-	-	-	783	783
Equity	-	-	-	4,859,726	4,859,726
International Equity Pool:					
Convertible Bonds	-	-	-	4,619	4,619
Equity	-	-	-	1,986,354	1,986,354
Total Fair Value	1,954,800	2,089,174	1,296,222	6,851,483	12,191,679
Net Pending Security					
Receivables (Payables)	(14,419)	(75,880)	(187,780)	11,293	(266,786)
Deposits	14,240	163,323	15,901	68,534	261,998
Total Net Assets at Fair Value before earnings distribution to participants	1,954,621	2,176,617	1,124,343	6,931,310	12,186,891
Earnings payable to participants	(1,828)	-	-	-	(1,828)
Ownership by the Retirement Fixed Income Pool	(163,323)	-	-	-	(163,323)
Ownership by Funds Under Other Fiduciary Responsibility	(1,788,361)	-	-	-	(1,788,361)
Ownership by Other Retirement Systems under ASPIB's Fiduciary Responsibility	(1,083)	(2,171,300)	(1,122,250)	(6,925,272)	(10,219,906)
MRS Invested Assets	\$ 26	\$ 5,317	\$ 2,092	\$ 6,038	\$ 13,473

Military Retirement System

Invested Assets

Notes to Schedules

June 30, 2004 and 2003

(4) DEPOSIT AND INVESTMENT RISK (Cont.)

Interest Rate Risk

Short-term Fixed Income Pool

As a means of limiting its exposure to fair value losses arising from increasing interest rates in the Short-term Fixed Income Pool, 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. When evaluating fixed rate securities, Treasury utilizes the actual maturity date for commercial paper and twelve-month prepay speeds for other securities. At June 30, 2004, the expected average life of individual fixed rate securities in the Short-term Fixed Income Pool ranged from one to six months and the expected average life of floating rate securities ranged from less than one year to 2.85 years.

Retirement and External Domestic Fixed Income Pools (domestic fixed income)

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, 2004, was 4.77 years.

At June 30, 2004, the effective duration of the domestic fixed income portfolio, by investment type, was as follows:

	<u>Effective Duration (in years)</u>
U.S. Treasury Notes	4.11
U.S. Treasury Bonds	8.71
U.S. Treasury Strips	21.14
U.S. Government Agency	5.31
Mortgage-related	4.02
Asset-backed	2.36
Corporate	5.54
Yankees	7.96
Portfolio Effective Duration	4.76

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, call options and other variable cash flows for purposes of the effective duration calculation.

Military Retirement System Invested Assets

Notes to Schedules June 30, 2004 and 2003

(4) DEPOSIT AND INVESTMENT RISK (Cont.)

Credit Risk

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

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 P1 or equivalent. In addition, Treasury's investment policy limits investments with regard to credit risk for the following investment types:

- Corporate debt must be investment grade and comprise those issued in the U.S. capital market by U.S. companies, Euro-dollar debt, or Yankee debt;
- Asset-backed securities must be investment grade;
- Mortgage-related securities must be issued or securitized by one of the following U.S. Government Agencies: Government National Mortgage Association; Federal National Mortgage Association; or the Federal Home Loan Mortgage Corporation.

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 P1 or equivalent;
- Corporate debt securities must be investment grade and comprise those issued in the U.S. capital market by U.S. companies, Euro-dollar debt, or Yankee debt;
- Corporate, asset-backed and non-agency mortgage securities must have a minimum rating of BBB or equivalent. For asset-backed and non-agency mortgage securities that are solely rated by Fitch or Duff & Phelps, they must have a AAA rating.

Domestic and International Equity:

- Commercial paper must bear the highest rating assigned and
- Corporate debt obligations must carry a rating of at least A or equivalent.

Military Retirement System Invested Assets

Notes to Schedules June 30, 2004 and 2003

(4) DEPOSIT AND INVESTMENT RISK (Cont.)

Credit Risk (Cont.)

At June 30, 2004, MRS Invested Assets consisted of securities with credit quality ratings issued by nationally recognized statistical rating organizations as follows:

	<u>Rating¹</u>	<u>Short-term Fixed Income Pool</u>	<u>Domestic Fixed Income Pools</u>	<u>International Equity Pool</u>
Short-term Investment Account (Deposit)	Not Rated	1%	-	-
Government Short-term Investment Fund (Deposit)	Not Rated	-	-	1%
Commercial Paper	A	18%	-	-
U. S. Government Agency Discount Notes	AAA	-	6%	-
U. S. Government Agency Mortgage-related	AAA	2%	5%	-
Mortgage-related	AAA	7%	32%	-
Mortgage-related Asset-backed	Not Rated ²	-	8%	-
Corporate	AAA	41%	3%	-
Corporate	AAA	2%	3%	-
Corporate	AA	8%	3%	-
Corporate	A	14%	7%	-
Corporate	BAA	-	1%	-
Corporate	BBB	-	8%	-
Investments with no credit exposure		7%	24%	99%

¹Rating modifiers are not disclosed.

²TBA's issued by U.S. Government Agencies allowed by policy.

Custodial Credit Risk – Deposits

Custodial credit risk is the risk that in the event of a bank failure, the deposits may not be returned. The Board does not have a formal policy for custodial credit risk. At June 30, 2004, JRS Invested Assets had the following uncollateralized and uninsured deposits:

	<u>Amount</u> <u>(in thousands)</u>
International Equity Pool	\$ <u><u>3</u></u>

Military Retirement System Invested Assets

Notes to Schedules June 30, 2004 and 2003

(4) DEPOSIT AND INVESTMENT RISK (Cont.)

Foreign Currency Risk

The Board's policy with regard to foreign currency risk is to restrict obligations to those issued in the currencies of countries represented in the family of Solomon Brothers World Government Bond Indices. The Board's asset allocation policy permits MRS to hold up to fifteen percent of total investments in international equity. At June 30, 2004, MRS invested assets included 12.54% in international equity.

At June 30, 2004, MRS had exposure to foreign currency risk with the following deposits:

<u>Currency</u>	<u>Amount</u> (in thousands)
Euro Currency	\$ 1
Japanese Yen	1
Pound Sterling	1
	<u>\$ 3</u>

At June 30, 2004, MRS had exposure to foreign currency risk with the following investments (stated in thousands):

<u>Currency</u>	<u>Convertible Bonds</u>	<u>Equity</u>
Australian Dollar	\$ -	\$ 13
Canadian Dollar	-	18
Danish Krone	-	1
Euro Currency	-	593
Hong Kong Dollar	-	22
Japanese Yen	3	296
New Zealand Dollar	-	12
Norwegian Krone	-	9
Pound Sterling	-	342
Singapore Dollar	-	26
South Korean Won	-	21
Swedish Krona	-	11
Swiss Franc	-	130
	<u>\$ 3</u>	<u>\$ 1,494</u>

Military Retirement System Invested Assets

Notes to Schedules June 30, 2004 and 2003

(4) DEPOSIT AND INVESTMENT RISK (Cont.)

Concentration of Credit Risk

Treasury does not have a policy with regard to concentration of credit risk for the Short-term Fixed Income Pool.

The Board's policy limits with regard to concentration of credit risk are as follows:

Domestic Fixed Income:

No more than ten percent of the currently outstanding par value of any corporate bond issue can be purchased.

At June 30, 2004, MRS invested assets included \$2,652,430 in Federal National Mortgage Association securities and \$942,540 in Federal Home Loan Mortgage Corporation which represented 19.72% and 7.01% of total MRS invested assets, respectively.

Military Retirement System Invested Assets

Notes to Schedules June 30, 2004 and 2003

(5) INVESTMENT INCOME (LOSS)

For the years ended June 30, investment income (loss) for each investment type includes the following components:

	2004		
	Interest and/or dividends	Net increase (decrease) in the fair value of investments	Total
Short-term Fixed Income Pool	\$ 511	\$ -	\$ 511
Retirement Fixed Income Pool	302,475	(229,700)	72,775
External Domestic Fixed Income Pool	79,127	(62,872)	16,255
Domestic Equity Pool	61,933	689,545	751,478
International Equity Pool	38,644	367,759 ⁽¹⁾	406,403
Total	<u>\$ 482,690</u>	<u>\$ 764,732</u>	<u>\$ 1,247,422</u>

⁽¹⁾ Includes net realized gains of \$84,165 and net unrealized gains of \$18 on foreign currency. Also includes net realized gains of \$103 on foreign exchange contracts.

	2003		
	Interest and/or dividends	Net increase (decrease) in the fair value of investments	Total
Short-term Fixed Income Pool	\$ 1,328	\$ -	\$ 1,328
Retirement Fixed Income Pool	281,862	223,284	505,146
External Domestic Fixed Income Pool	82,071	141,380	223,451
Domestic Equity Pool	66,717	53,238	119,955
International Equity Pool	31,733	(110,358) ⁽¹⁾	(78,625)
Total	<u>\$ 463,711</u>	<u>\$ 307,544</u>	<u>\$ 771,255</u>

⁽¹⁾ Includes net realized gains of \$17,811 and net unrealized losses of \$22 on foreign currency. Also includes net realized losses of \$1,204 on foreign exchange contracts.

Military Retirement System Invested Assets

Notes to Schedules June 30, 2004 and 2003

(6) FOREIGN EXCHANGE CONTRACTS AND OFF-BALANCE SHEET RISK

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 forty-five to ninety-six days. MRS had net unrealized gains (losses) with respect to such contracts, calculated using forward rates at June 30, as follows:

	<u>2004</u>	<u>2003</u>
Net Contract Sales	\$ 5,580	\$ 1,097
Less: Fair Value	<u>5,647</u>	<u>1,083</u>
Net unrealized gains (losses) on contracts	<u>\$ (67)</u>	<u>\$ 14</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.

(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 market value. In January 2001, the Board entered into an agreement with State Street Corporation (the Bank) to lend fixed income, domestic equity and international equity 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, 2004 and 2003, the fair value of securities on loan allocable to MRS Invested Assets totaled \$2,088,449 and \$1,049,716, 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 fully collateralized at not less than 105 percent of their fair value. All other security loans are fully collateralized at not less than 102 percent of their fair value. The Bank invests the cash collateral in a commingled investment pool; maturities of these investments generally did not match the maturities of the loaned securities because the lending agreements are terminable at will. The Bank may pledge or sell collateral upon borrower default. Since the Board does not have the ability to pledge or sell the collateral unless the borrower defaults, no assets or liabilities are recorded on the financial schedules. 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 subject to limitation relating to war, civil unrest or revolution, or beyond the reasonable control of the Bank. The Bank and the borrower receive a fee from earnings on invested collateral.

For the year ended June 30, 2004 and 2003, 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.