



**STATE OF NEW JERSEY  
POLICE AND FIREMEN'S RETIREMENT SYSTEM**

Financial Statements and Schedules

June 30, 2006 and 2005

(With Independent Auditors' Report Thereon)



**KPMG LLP**  
Suite 402  
301 Carnegie Center  
Princeton, NJ 08540-6227

## **Independent Auditors' Report**

The Board of Trustees  
State of New Jersey  
Police and Firemen's Retirement System:

We have audited the accompanying statements of fiduciary net assets of the State of New Jersey Police and Firemen's Retirement System (the System) as of June 30, 2006 and 2005, and the related statements of changes in fiduciary net assets for the years then ended. These financial statements are the responsibility of the System's 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 consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the System's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, 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, the financial position of the State of New Jersey Police and Firemen's Retirement System as of June 30, 2006 and 2005, and the changes in its financial position for the years then ended in conformity with U.S. generally accepted accounting principles.

Management's Discussion and Analysis and the supplementary information included in the schedule of funding progress and schedule of employer contributions (Schedules 1 and 2) are not a required part of the basic financial statements but are supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audits were made for the purpose of forming an opinion on the financial statements that collectively comprise the System's basic financial statements. The 2006 schedule of changes in fiduciary net assets by fund (Schedule 3) is presented for purposes of additional analysis and is not a required part of the basic financial statements of the System. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly presented in all material respects in relation to the financial statements taken as a whole.

**KPMG LLP**

January 25, 2007

**STATE OF NEW JERSEY**  
**POLICE AND FIREMEN'S RETIREMENT SYSTEM**

Management's Discussion and Analysis

June 30, 2006 and 2005

Our discussion and analysis of the Police and Firemen's Retirement System (the System) financial performance provides an overview of the System's financial activities for the fiscal years ended June 30, 2006 and 2005. Please read it in conjunction with the basic financial statements and financial statement footnotes which follow this discussion.

**FINANCIAL HIGHLIGHTS**

**2006 - 2005**

- Net assets held in trust for pension benefits increased by \$1,515,207,306 as a result of fiscal year 2006's operations from \$17,409,979,351 to \$18,925,186,657.
- Additions for the year were \$2,680,273,651, which are comprised of member and employer pension contributions of \$1,004,892,715 and investment income of \$1,675,380,936.
- Deductions for the year were \$1,165,066,345, which are comprised of benefit and refund payments of \$1,160,135,537 and administrative expenses of \$4,930,808.

**2005 - 2004**

- Net assets held in trust for pension benefits increased by \$1,056,783,019 as a result of fiscal year 2005's operations from \$16,353,196,332 to \$17,409,979,351.
- Additions for the year were \$2,132,819,383, which are comprised of member and employer pension contributions of \$749,422,997 and investment income of \$1,383,396,386.
- Deductions for the year were \$1,076,036,364, which are comprised of benefit and refund payments of \$1,070,072,289 and administrative expenses of \$5,964,075.

**THE STATEMENTS OF FIDUCIARY NET ASSETS AND THE STATEMENTS OF CHANGES IN FIDUCIARY NET ASSETS**

This annual report consists of two financial statements: *The Statements of Fiduciary Net Assets* and *The Statements of Changes in Fiduciary Net Assets*. These financial statements report information about the System and about its activities to help you assess whether the System, as a whole, has improved or declined as a result of the year's activities. The financial statements were prepared using the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized in the period they are earned and expenses are recorded in the year they are incurred, regardless of when cash is received or paid.

*The Statements of Fiduciary Net Assets* show the balances in all of the assets and liabilities of the System at the end of the fiscal year. The difference between assets and liabilities represents the System's fiduciary net assets. Over time, increases or decreases in the System's fiduciary net assets provide one indication of whether the financial health of the System is improving or declining. *The Statements of Changes in Fiduciary Net Assets* show the results of financial operations for the year. The statements provide an explanation for the change in the System's fiduciary net assets since the prior year. These two financial statements should be reviewed along with the information contained in the financial statement footnotes, including the required supplementary schedules, to determine whether the System is becoming financially stronger or weaker.

**STATE OF NEW JERSEY  
POLICE AND FIREMEN'S RETIREMENT SYSTEM**

Management's Discussion and Analysis

June 30, 2006 and 2005

FINANCIAL ANALYSIS

SCHEDULE OF FIDUCIARY NET ASSETS

2006 - 2005

	2006	2005	Increase (Decrease)
Assets	\$21,964,507,424	\$20,082,541,678	\$1,881,965,746
Liabilities	3,039,320,767	2,672,562,327	366,758,440
Net Assets	\$18,925,186,657	\$17,409,979,351	\$1,515,207,306

The System's assets mainly consist of cash, securities lending collateral, investments, and contributions due from members and participating employers. Between fiscal years 2005 and 2006, total assets increased by \$1.9 billion or 9.4%. The total assets increased due to an increase in contributions receivable from employers, an overall increase in fair value of investments, and an increase in securities lending collateral. Employer contributions receivables include contribution receivables from local employers for appropriations due April 1, 2007 and 2008 based on Chapter 108, P.L. 2003 and for early retirement incentive benefits to local employees based on Chapter 130, P.L. 2003.

Liabilities consist of pension and death benefit payments owed to members and beneficiaries, noncontributory group insurance premiums owed to the System's insurance provider, securities lending collateral and rebates payable, and other payables. Total liabilities increased by \$366.8 million or 13.7% over last year. This is mainly due to an increase in retirement benefits payable to increased number of retirees and also an increase in securities lending collateral and rebates payable

Net assets held in trust for pension benefits increased by \$1.5 billion or 8.7%.

2005 - 2004

	2005	2004	Increase (Decrease)
Assets	\$20,082,541,678	\$18,686,939,642	\$1,395,602,036
Liabilities	2,672,562,327	2,333,743,310	338,819,017
Net Assets	\$17,409,979,351	\$16,353,196,332	\$1,056,783,019

Between fiscal years 2004 and 2005, total assets increased by \$1.4 billion or 7.5%. The total assets increased due to an increase in contributions receivable from employers and also overall increase in fair value of investments. Employer contributions receivables include contribution receivables from local employers for appropriations due April 1, 2006 and 2007 based on Chapter 108, P.L. 2003 and for early retirement incentive benefits to local employees based on Chapter 130, P.L. 2003. The original June 30, 2003 valuation for local employers was revised due to the change in economic assumptions which would affect the fiscal year 2006 employer contributions.

Total liabilities increased by \$338.8 million or 14.5% over last year. This is mainly due to an increase in retirement benefit payables.

Net assets held in trust for pension benefits increased by \$1.1 billion or 6.5%.

**STATE OF NEW JERSEY  
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Management's Discussion and Analysis

June 30, 2006 and 2005

**ADDITIONS TO FIDUCIARY NET ASSETS  
2006 - 2005**

	2006	2005	Increase (Decrease)
Member Contributions	\$290,681,716	\$276,195,076	\$14,486,640
Employer Contributions	714,210,999	473,227,921	240,983,078
Investment & Other	1,675,380,936	1,383,396,386	291,984,550
<b>Totals</b>	<b>\$2,680,273,651</b>	<b>\$2,132,819,383</b>	<b>\$547,454,268</b>

Additions primarily consist of member and employer contributions and earnings from investment activities. Member contributions rose by \$14.5 million or 5.2% due to increased membership.

Employer contributions increased by \$241.0 million or 50.9%. In fiscal year 2006, employer contributions include accrued appropriations due April 1, 2007 and 2008, based on Chapter 108, P.L. 2003.

The Chapter 108, effective July 1, 2003, provided that local employer PFRS normal and accrued liability contributions will be 80% and 100% of the amount certified by the PFRS for payments due in State fiscal year 2007 and 2008, respectively.

The State made a contribution of \$73.5 million for fiscal year 2006 pension obligation. According to the Appropriation Act of 2003 related to fiscal year 2006, the State is paying pension obligations through a five-year phase-in.

Investment & other revenues increased by \$292.0 million or 21.1% due to increase in net appreciation in fair value of investments and a higher rate of return on investments.

The total investment return for all pension funds was estimated to be 9.7% compared to 8.7% in the prior year.

**2005 - 2004**

	2005	2004	Increase (Decrease)
Member Contributions	\$276,195,076	\$263,173,065	\$13,022,011
Employer Contributions	473,227,921	264,164,091	209,063,830
Investment & Other	1,383,396,386	1,943,638,309	(560,241,923)
<b>Totals</b>	<b>\$2,132,819,383</b>	<b>\$2,470,975,465</b>	<b>\$(338,156,082)</b>

Member contributions rose by \$13.0 million or 5.0% due to increased membership.

Employer contributions increased by \$209.1 million or 79.1%. In fiscal year 2005, employer contributions include accrued appropriations due April 1, 2006 and 2007, based on Chapter 108, P.L. 2003. The original June 30, 2003 valuation for local employers was revised due to the change in economic assumptions which would affect the fiscal year 2006 employer contributions.

The Chapter 108, effective July 1, 2003, provided that local employer PFRS normal and accrued liability contributions will be 60% and 80% of the amount certified by the PFRS for payments due in State fiscal year 2006 and 2007, respectively and thereafter a percentage of the amount certified by the System as the State Treasurer will determine. According to the Appropriation Act for fiscal year 2005, the State as well is paying pension obligations through a five-year phase-in.

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Management's Discussion and Analysis

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For fiscal year 2005, the 50% of available excess valuation assets could be utilized to offset normal contributions. Thereafter, a certain percentage of available excess valuation assets may be used as specified in the legislation. The normal contribution for basic pension benefits, noncontributory death benefits, and cost-of-living adjustments was funded by excess valuation assets in accordance with Chapter 115 (P.L. 1997).

Investment & other revenues decreased by \$560.2 million or 28.8% due to decrease in net appreciation in fair value of investments.

The total investment return for all pension funds was estimated to be 8.7% compared to 14.2% in the prior year.

**DEDUCTIONS FROM FIDUCIARY NET ASSETS**

2006 - 2005

	2006	2005	Increase (Decrease)
Benefits	\$1,153,490,795	\$1,064,463,253	\$89,027,542
Refunds & Adjustments	6,644,742	5,609,036	1,035,706
Administrative Expenses	4,930,808	5,964,075	(1,033,267)
<b>Totals</b>	<b>\$1,165,066,345</b>	<b>\$1,076,036,364</b>	<b>\$89,029,981</b>

Deductions are mainly comprised of pension benefit payments to retirees and beneficiaries, refunds of contributions to former members, and administrative costs incurred by the System. Benefit payments increased by \$89.0 million or 8.4% primarily due to an increase in number of retirees receiving benefits. The number of refunds processed increased by \$1.0 million or 18.5%. Administrative expenses decreased by \$1.0 million or 17.3%. Last year's administrative expense was higher due to the reimbursement to the State General Fund of the Special Project Fund Appropriation utilized for the system reengineering project.

2005 - 2004

	2005	2004	Increase (Decrease)
Benefits	\$1,064,463,253	\$987,055,680	\$77,407,573
Refunds & Adjustments	5,609,036	7,148,274	(1,539,238)
Administrative Expenses	5,964,075	3,530,770	2,433,305
<b>Totals</b>	<b>\$1,076,036,364</b>	<b>\$997,734,724</b>	<b>\$78,301,640</b>

Benefit payments increased by \$77.4 million or 7.8% primarily due to an increase in number of retirees receiving benefits. The number of refunds processed decreased by 21.5%. Administrative expenses increased by \$2.4 million or 68.9% mainly due to the reimbursement to the State General Fund for the Special Project Fund Appropriation for the system reengineering project.

**RETIREMENT SYSTEM AS A WHOLE**

The overall funded ratios of 80.1% for fiscal year 2006 and 84.0% for 2005 indicate that the System is reasonably funded.

**CONTACTING SYSTEM FINANCIAL MANAGEMENT**

The financial report is designed to provide our members, beneficiaries, investors and other interested parties with a general overview of the System's finances and to show the System's accountability for the money it receives. If you have any questions about this report or need additional financial information, contact the Division of Pensions and Benefits, P.O. Box 295, Trenton, NJ 08625-0295.

**STATE OF NEW JERSEY  
POLICE AND FIREMEN'S RETIREMENT SYSTEM**

Statements of Fiduciary Net Assets

June 30, 2006 and 2005

	<b>2006</b>	<b>2005</b>
<b>Assets:</b>		
Cash	\$ 2,131,532	—
Securities Lending Collateral	3,004,838,828	2,578,670,674
Investments, at fair value:		
Cash Management Fund	433,773,534	538,642,642
Bonds	945,271	3,052,179
Common Pension Fund A	8,534,696,154	8,267,954,828
Common Pension Fund B	3,584,064,503	3,250,307,191
Common Pension Fund D	3,371,942,503	3,141,068,036
Common Pension Fund E	284,423,836	—
Mortgage Backed Securities	1,033,780,638	991,411,345
Total investments	17,243,626,439	16,192,436,221
Receivables:		
Contributions:		
Members	49,697,767	47,861,340
Employers	1,092,948,923	701,894,418
Accrued interest and dividends	112,786,319	85,743,875
Members' loans	443,360,063	451,221,016
Other	15,117,553	24,714,134
Total receivables	1,713,910,625	1,311,434,783
Total assets	21,964,507,424	20,082,541,678
<b>Liabilities:</b>		
Accounts payable and accrued expenses	1,336,028	1,640,149
Retirement benefits payable	29,515,041	88,473,032
Non-contributory group insurance premiums payable	3,630,870	2,227,401
Cash overdraft	—	1,551,071
Securities lending collateral and rebates payable	3,004,838,828	2,578,670,674
Total liabilities	3,039,320,767	2,672,562,327
<b>Net Assets:</b>		
Held in trust for pension benefits	\$ 18,925,186,657	17,409,979,351

See schedule of funding progress on pages 26-27.

See accompanying notes to financial statements.

**STATE OF NEW JERSEY  
POLICE AND FIREMEN'S RETIREMENT SYSTEM**

Statements of Changes in Fiduciary Net Assets

Years ended June 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
<b>Additions:</b>		
Contributions:		
Members	\$ 290,681,716	276,195,076
Employers	714,210,999	473,227,921
Total contributions	<u>1,004,892,715</u>	<u>749,422,997</u>
Investment income:		
Net appreciation in fair value of investments	1,059,993,931	932,344,545
Interest	439,352,270	285,746,114
Dividends	176,460,595	166,201,533
	<u>1,675,806,796</u>	<u>1,384,292,192</u>
Less: investment expense	<u>425,860</u>	<u>895,806</u>
Net investment income	<u>1,675,380,936</u>	<u>1,383,396,386</u>
Total additions	<u>2,680,273,651</u>	<u>2,132,819,383</u>
<b>Deductions:</b>		
Benefits	1,153,490,795	1,064,463,253
Refunds of contributions	6,644,742	5,609,036
Administrative expenses	4,930,808	5,964,075
Total deductions	<u>1,165,066,345</u>	<u>1,076,036,364</u>
Change in net assets	1,515,207,306	1,056,783,019
Net Assets - Beginning of year	<u>17,409,979,351</u>	<u>16,353,196,332</u>
Net Assets - End of year	<u>\$ 18,925,186,657</u>	<u>17,409,979,351</u>

See accompanying notes to financial statements.

**STATE OF NEW JERSEY  
POLICE AND FIREMEN'S RETIREMENT SYSTEM**

Notes to Financial Statements

June 30, 2006 and 2005

**(1) DESCRIPTION OF THE SYSTEM**

State of New Jersey Police and Firemen's Retirement System (the System; PFRS) is a cost-sharing multiple-employer contributory defined benefit plan which was established as of July 1, 1944, under the provisions of N.J.S.A. 43:16A. The System is included along with other state-administered pension trust and agency funds in the basic financial statements of the State of New Jersey.

At June 30, 2005 and 2004, the dates of the most recent actuarial valuations, participating employers consisted of the following:

	<u>2005</u>	<u>2004</u>
State of New Jersey	1	1
Municipalities	<u>584</u>	<u>585</u>
Total	<u>585</u>	<u>586</u>

The System's designated purpose is to provide retirement, death and disability benefits to its members. Membership in the System is mandatory for substantially all full-time county and municipal police or firemen, and state firemen or officer employees with police powers appointed after June 30, 1944. The System's Board of Trustees is primarily responsible for its administration.

According to State of New Jersey Administrative Code, all obligations of the System will be assumed by the State of New Jersey should the System terminate.

***Vesting and Benefit Provisions:***

The vesting and benefit provisions are set by N.J.S.A. 43:16A and 43:3B. The System provides retirement as well as death and disability benefits. All benefits vest after ten years of service except disability benefits which vest after four years of service. Retirement benefits for age and service are available at age 55 and are generally determined to be 2% of final compensation for each year of creditable service, as defined, up to 30 years plus 1% for each year of service in excess of 30 years. Final compensation equals the compensation for the final year of service prior to retirement. Members may seek special retirement after achieving 25 years of creditable service or they may elect deferred retirement after achieving ten years of service, in which case benefits would begin at age 55 equal to 2% of final compensation for each year of service. The annual benefit under special retirement is 65% of the member's final compensation plus 1% for each year of creditable service over 25 years but not to exceed 30 years. The maximum allowance is therefore 70 percent of final compensation.

Widow/widowers of members retired since December 18, 1967 receive 50% of the retiree's final compensation. The minimum annual widow/widower's benefits of an accidental disability retiree prior to December 18, 1967 and of all retirees since December 18, 1967 is \$4,500.

Members are always fully vested for their own contributions. In the case of death before retirement, members' beneficiaries are entitled to full payment of members' contributions providing no survivor death benefits are payable.

**STATE OF NEW JERSEY  
POLICE AND FIREMEN'S RETIREMENT SYSTEM**

Notes to Financial Statements

June 30, 2006 and 2005

Eligible retirees receiving monthly benefits are entitled to cost-of-living increases equal to 60% of the change in the average consumer price index for the calendar year in which the pensioner retired as compared to the average consumer price index for a 12-month period ending with each August 31st immediately preceding the year in which the adjustment becomes payable. The regular retirement allowance is multiplied by the 60% factor as developed and results in the dollar amount of the adjustment payable. Retired members become eligible for pension adjustment benefits after 24 months of retirement. The cost-of-living increases are funded by the retirement system and are included in the annual actuarial calculations of the required state and state-related employer contributions.

Chapter 4, P.L. 2001 provided increased benefits to certain members who retired prior to December 29, 1989 with at least 25 years of creditable service. The maximum amount of the increase was 5% of the retiree's final compensation. For those with 30 or more years of service, the total pension benefit would increase from 65% to 70% of final compensation.

***Significant Legislation:***

Chapter 130, P.L. 2003, effective July 14, 2003, provided employees of local employers with additional retirement benefits through early retirement incentive programs. It also permitted issuance of refunding bonds to fund benefits

Chapter 108 (P.L. 2003), effective July 1, 2003, provided that local employer PFRS normal and accrued liability contributions will be 20% of the amount certified by the PFRS for payments due in State fiscal year 2004 and thereafter a percentage of the amount certified by the System as the State Treasurer will determine, but not more than 40% in fiscal year 2005, not more than 60% in fiscal year 2006, and not more than 80% in fiscal year 2007. According to the Appropriation Act of 2003, the State as well is paying pension obligations through a five-year phase-in.

***Membership:***

Membership in the System consisted of the following at June 30, 2005 and 2004, the dates of the most recent actuarial valuations:

	<u>2005</u>	<u>2004</u>
Retirees and beneficiaries currently receiving benefits and terminated employees entitled to benefits but not yet receiving them	<u>29,321</u>	<u>27,932</u>
Active members:		
Vested	27,894	27,386
Non-vested	<u>16,317</u>	<u>16,810</u>
Total active members	<u>44,211</u>	<u>44,196</u>
Total	<u>73,532</u>	<u>72,128</u>

**STATE OF NEW JERSEY  
POLICE AND FIREMEN'S RETIREMENT SYSTEM**

Notes to Financial Statements

June 30, 2006 and 2005

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

***Measurement Focus and Basis of Accounting:***

The accounting and financial reporting treatment applied to a fund is determined by its measurement focus. The System is accounted for using an economic resources measurement focus.

The accrual basis of accounting is used for measuring financial position and changes in fiduciary net assets of the System. Under this method, revenues are recorded in the accounting period in which they are earned, and deductions are recorded at the time the liabilities are incurred. The financial statements of the System conform to the provisions of Governmental Accounting Standards Board (GASB) Statement No. 25, "Financial Reporting for Defined Benefit Plans and Note Disclosures for Defined Contributions Plans." Employer contributions are recognized when payable to the System. Benefits and refunds are recognized when due and payable in accordance with the terms of the System.

***Valuation of Investments:***

Investments are reported at fair value as follows:

- U.S. Government and Agency, Foreign and Corporate obligations – prices quoted by a major dealer in such securities.
- Common Stock and Equity Funds, Foreign Equity Securities, Forward Foreign Exchange Contracts – closing prices as reported on the primary market or exchange on which they trade.
- Money Market Instruments – amortized cost which approximates fair value.
- Cash Management Fund – closing bid price on the last day of trading during the period as determined by the Transfer Agent.
- Alternative investments (private equity, real assets and absolute return strategy funds) – estimated fair value provided by the investment manager and reviewed by management. Because alternative investments are not readily marketable, their estimated value is subject to uncertainty and therefore may differ significantly from the value that would be used if a ready market for such investments existed. Accordingly, the realized value received upon the sale of the asset may differ from the fair value.

***Investment Transactions:***

Investment transactions are accounted for on a trade date basis. Gains and losses from investment transactions are determined by the average cost method. Interest and dividend income is recorded on the accrual basis, with dividends accruing on the ex-dividend date.

***Unit Transactions:***

The net asset value of Common Funds A, B, D and E (Common Funds) is determined as of the close of the last day of business of each month. Purchases and redemptions of participants' units are transacted each month within fifteen days subsequent to that time and at such net asset value.

Dividends and interest earned per unit are calculated monthly and distributed quarterly for Common Fund A and B. Dividends and interest earned per unit are calculated monthly for Common Fund D, and the income earned on Common Fund D units is reinvested. Income earned per unit is calculated monthly for Common Fund E, and the income earned on Common Fund E units is reinvested.

**STATE OF NEW JERSEY  
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Notes to Financial Statements

June 30, 2006 and 2005

***Securities Lending:***

Common Funds A, B and D and several of the directly-held pension plan portfolios participate in securities lending programs, whereby securities are loaned to brokers or to other borrowers and, in return, the pension funds have rights to the collateral received. All of the securities held in Common Funds A, B and D, and certain securities held directly by the pension plans, are eligible for the securities lending program. Collateral received may consist of cash, letters of credit, or government securities having a market value equal to or exceeding 102% (U.S. dollar denominated) or 105% (non-U.S. dollar denominated) of the value of the loaned securities at the time the loan is made. For Common Funds A and B, in the event that the market value of the collateral falls below 101% of the market value of all the outstanding loaned securities to an individual borrower, additional collateral shall be transferred by the borrower to the respective funds no later than the close of the next business day so that the market value of such additional collateral, when added to the market value of the other collateral, shall equal 102% of the market value of the loaned securities. For Common Fund D, in the event that the market value of the collateral falls below the collateral requirement of either 102% or 105% of the market value of the outstanding loaned securities to an individual borrower, additional collateral shall be transferred in an amount that will increase the aggregate of the borrower's collateral to meet the collateral requirements. As of June 30, 2006 and 2005, the Common Funds have no aggregate credit risk exposure to brokers because the collateral amount held by the Common Funds exceeded the market value of the securities on loan.

The contracts with the Common Funds' custodian banks require them to indemnify the Common Funds if the brokers fail to return the securities or fail to pay the Common Funds for income distributions on the securities while they are on loan. The custodian bank for Common Fund D also indemnifies Common Funds for any loss of principal or interest on the invested collateral. For any losses on the investment collateral in Common Funds A or B or other pension plan portfolios, the lending fee paid to the lending agent shall be reduced by 25% of the amount of such loss, up to an amount not to exceed 75% of the previous six months' securities lending fees. The securities loans can be terminated by notification by either the borrower or the Common Funds. The term to maturity of the securities loans is generally matched with the term to maturity of the investment of the cash collateral.

***Derivatives:***

The Common Funds' international portfolio managers utilize forward foreign currency contracts, a derivative security, as a means to hedge against the currency risk in the Common Funds' foreign stock and fixed income portfolios. A derivative security is an investment whose payoff depends upon the value of other assets such as bond and stock prices, a market index, or commodity prices. Derivative transactions involve, to varying degrees, credit risk and market risk. Credit risk is the possibility that a loss may occur because a party to a transaction fails to perform according to terms. Market risk is the possibility that a change in market prices or currency rates will cause the value of a financial instrument to decrease or become more costly to settle.

Forward foreign currency contracts are agreements to buy or sell a specific amount of a foreign currency at a specified delivery or maturity date for an agreed upon price. Forward foreign currency contracts are used to hedge against the currency risk in the Common Funds' foreign stock and fixed income portfolios.

**STATE OF NEW JERSEY  
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Notes to Financial Statements

June 30, 2006 and 2005

The fair value of foreign forward currency contracts held directly by the Common Funds as of June 30, 2006 and 2005 is as follows:

	<u>2006</u>	<u>2005</u>
Forward currency receivable	\$ 1,887,515,323	745,577,063
Forward currency payable	1,902,654,117	745,525,163
Net unrealized loss (gain)	15,138,794	(51,900)

The net unrealized gain or loss is included in investments in the accompanying statements of net assets at June 30, 2006 and 2005.

The Common Funds utilize covered call and put options in an effort to add value to or reduce the risk level in the portfolio. Covered options are agreements that give the owner of the option the right, but not obligation, to buy (in the case of a call option) or to sell (in the case of a put option) a specific amount of an asset for a specific price (called the strike price) on or before a specified expiration date. The writer of call options receives a premium at the outset of the agreement and bears the risk of an unfavorable change in the price of the instrument underlying the option. The Common Funds have written call options on 182,000 shares with a fair value of \$470,032 at June 30, 2006 and 215,400 shares with a fair value of \$548,100 at June 30, 2005 which are reflected as contra-assets to the fair value of the portfolio. The Common Funds own put options on 6,990,800 shares with a fair value of \$1,631,358, which are included in the portfolio at June 30, 2006.

Certain alternative investment funds and partnerships may use derivative instruments to hedge against market risk and to enhance investment returns. At any point during the year, the Common Funds may have additional exposure to derivatives primarily through limited liability vehicles such as limited partnerships and commingled investment funds.

***Members' Loans:***

Members who have at least three years of service in the System may borrow up to 50% of their accumulated member contributions. Repayment of loan balances is deducted from payroll checks and bears an interest rate of 4%. Members who retire with an outstanding loan have the option of paying the loan in full prior to receiving any benefits or continuing their monthly loan payment schedule into retirement.

Under the Internal Revenue Service regulations effective January 1, 2004, the Division changed its pension loan repayment policy: Members who take multiple loans must repay the outstanding balance of the original loan, and all subsequent loans taken before the original loan is completely paid off, within a period not to exceed 5 years from the issuance of the first loan taken after January 1, 2004. Failure to repay the loan within the five-year period will result in the unpaid balance being declared a taxable distribution.

***Administrative Expenses:***

The System is administered by the State of New Jersey Division of Pensions and Benefits. Administrative expenses are paid by the System to the State of New Jersey, Department of the Treasury and are included in the accompanying statements of changes in fiduciary net assets.

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**(3) INVESTMENTS**

The System is invested in Common Pension Fund A, Common Pension Fund B, Common Pension Fund D, Common Pension Fund E, and other investments, including bonds and mortgage backed securities, which represent 23.48%, 19.55%, 23.48%, 25.55%, and 77.37%, respectively, of each investment total of the pension funds as of June 30, 2006.

The System was invested in Common Pension Fund A, Common Pension Fund B, Common Pension Fund D, and other investments, including bonds and mortgage backed securities, which represent 23.24%, 18.58%, 22.95%, and 78.85%, respectively, of each investment total of the pension funds as of June 30, 2005.

The pension funds investments as of June 30 are as follows:

	<u>2006</u>	<u>2005</u>
Domestic equities	\$ 36,206,866,148	34,782,276,119
International equities	12,953,297,531	11,232,483,997
Domestic fixed income	16,949,855,296	16,521,446,786
International fixed income	1,187,184,887	2,201,826,936
Domestic floating rate securities	77,882,139	77,922,181
Police and Fireman's mortgages	965,008,210	896,706,544
Private equity	236,208,692	—
Real estate	81,345,789	—
Absolute return strategy funds	260,707,666	—
Net forward foreign exchange contracts	(15,138,794)	51,900
	<u>\$ 68,903,217,564</u>	<u>65,712,714,463</u>

New Jersey state statute provides for a State Investment Council (Council) and a Director. Investment authority is vested in the Director of the Division and the role of the Council is to formulate investment policies. The Council issues regulations which establish guidelines for permissible investments which include domestic and international equities, obligations of the U.S. Treasury, government agencies, corporations, finance companies and banks, international government and agency obligations, Canadian obligations, New Jersey State and Municipal general obligations, public authority revenue obligations, collateralized notes and mortgages, commercial paper, certificates of deposit, repurchase agreements, bankers acceptances, guaranteed income contracts and money market funds, private equity, real estate, other real assets and absolute return strategy funds.

The pension funds investments are subject to various risks. Among these risks are credit risk, concentration of credit risk, interest rate risk and foreign currency risk. Each one of these risks is discussed in more detail below.

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 evaluated by nationally recognized statistical rating agencies such as Moody's Investors Service, Inc. (Moody's) or Standard & Poor's Corporation (S&P). Concentration of credit risk is the risk of loss attributed to the magnitude of an investment in a single issuer. There are no restrictions in the

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amount that can be invested in United States treasury and government agency obligations. Council regulations require minimum credit ratings for certain categories of fixed income obligations held directly by the pension funds and limit the amount that can be invested in any one issuer or issue as follows:

<u>Category</u>	<u>Minimum Rating</u>		<u>Limitation of Issuer's Outstanding Debt</u>	<u>Limitation of Issue</u>	<u>Other Limitations</u>
	<u>Moody's</u>	<u>S&amp;P</u>			
Corporate obligations	Baa	BBB	25%	25%	—
U.S. finance company debt, bank debentures and NJ state & municipal obligations	A	A	10%	10%	—
Canadian obligations	A	A	10%	10%	Purchase cannot exceed greater of 10% of issue or \$10 million; not more than 2% of fund assets can be invested in any one issuer
International government and agency obligations	Aa	AA	2%	10%	Not more than 1% of fund assets can be invested in any one issuer
Public Authority revenue obligations	A	A	—	10%	Not more than 2% of fund assets can be invested in any one public authority
Collateralized notes and mortgages	Baa	BBB	—	33.3%	Not more than 2% of fund assets can be invested in any one issuer
Commercial paper	P-1	A-1	—	—	—
Certificates of deposit and Banker's acceptances (rating applies to international)	Aa/P-1	—	—	—	Uncollateralized certificates of deposit and banker's acceptances cannot exceed 10% of issuer's primary capital
Guaranteed income contracts	P-1	—	—	—	A+ rating from A.M. Best for insurance companies
Money market funds	—	—	—	—	Not more than 10% of fund assets can be invested in money market funds; limited to 5% of shares or units outstanding

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For securities in the fixed income portfolio, the following tables disclose aggregate market value, by major credit quality rating category at June 30, 2006 and 2005:

June 30, 2006 (000's)	Moody's Rating				
	Aaa	Aa	A	Baa	Ba
United States Treasury Notes	\$ 3,516,004	—	—	—	—
United States Treasury Bills	389,716	—	—	—	—
United States Treasury TIPS	790,555	—	—	—	—
United States Treasury Bonds	1,984,003	—	—	—	—
United States Treasury Strips	37,219	—	—	—	—
Title XI Merchant Marine Notes	3,615	—	—	—	—
Federal Agricultural Mortgage Corp. Notes	95,763	—	—	—	—
Federal Farm Credit Bank Bonds	50,270	—	—	—	—
Federal Home Loan Bank Bonds	466,312	—	—	—	—
Federal Home Loan Bank Discounted Notes	89,894	—	—	—	—
Federal Home Loan Mortgage Corp. Notes	341,897	—	—	—	—
Federal National Mortgage Association Notes	226,193	—	—	—	—
Resolution Funding Corp. Obligations	6,397	—	—	—	—
Floating Rate Notes	25,023	20,020	9,999	22,841	—
Corporate Obligations	509,357	674,474	2,172,927	1,545,710	—
Real Estate Investment Trust Obligations	—	—	—	93,436	—
Finance Company Debt	217,653	623,016	626,864	9,097	55,587
Supranational Obligations	75,512	—	—	—	—
International Bonds and Notes	208,740	99,215	19,539	—	—
Foreign Government Obligations	470,461	313,716	—	—	—
Remic/FHLMC	731,131	—	—	—	—
Remic/FNMA	67,108	—	—	—	—
Remic/GNMA	17,650	—	—	—	—
GNMA Mortgage Backed Certificates	78,051	—	—	—	—
FHLM Mortgage Backed Certificates	598,915	—	—	—	—
FNMA Mortgage Backed Certificates	620,790	—	—	—	—
Asset Backed Obligations	178,119	—	—	—	—
Private Export Obligations	55,971	—	—	—	—
Exchange Traded Securities	—	—	51,735	—	—
	<u>\$ 11,852,319</u>	<u>1,730,441</u>	<u>2,881,064</u>	<u>1,671,084</u>	<u>55,587</u>

The table does not include certain corporate obligations totaling \$24,426,500 which have an S&P rating of A and do not have a Moody's rating. The Police and Firemen's Mortgages and the Cash Management fund are unrated.

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June 30, 2005 (000's)	Moody's Rating			
	Aaa	Aa	A	Baa
United States Treasury Notes	\$ 1,813,358	—	—	—
United States Treasury TIPS	598,125	—	—	—
United States Treasury Bonds	2,193,224	—	—	—
United States Treasury Strips	42,326	—	—	—
Title XI Merchant Marine Notes	3,956	—	—	—
Federal Agricultural Mortgage Corp. Notes	—	101,698	—	—
Federal Farm Credit Bank Bonds	102,225	—	—	—
Federal Home Loan Bank Bonds	521,527	—	—	—
Federal Home Loan Bank Discounted Notes	4,244	—	—	—
Federal Home Loan Mortgage Corp. Notes	265,077	26,953	—	—
Federal National Mortgage Association Notes	698,324	26,078	—	—
Resolution Funding Corp. Obligations	7,337	—	—	—
Floating Rate Notes	25,026	19,983	9,999	22,914
Corporate Obligations	645,239	594,643	2,722,186	1,310,398
Real Estate Investment Trust Obligations	—	—	—	99,301
Finance Company Debt	285,528	963,800	757,113	132,094
Supranational Obligations	122,496	—	—	—
International Bonds and Notes	420,419	—	—	—
Foreign Government Obligations	1,293,765	283,284	58,319	—
Remic/FHLMC	638,865	—	—	—
Remic/FNMA	73,982	—	—	—
Remic/GNMA	17,993	—	—	—
GNMA Mortgage Backed Certificates	112,091	—	—	—
FHLM Mortgage Backed Certificates	774,802	—	—	—
FNMA Mortgage Backed Certificates	645,810	—	—	—
Asset Backed Obligations	252,973	—	—	—
Private Export Obligations	34,127	—	—	—
Exchange Traded Securities	—	—	56,050	—
	\$ 11,592,839	2,016,439	3,603,667	1,564,707

The table does not include certain investments which do not have a Moody's rating which include foreign government obligations totaling \$18,842,884 with an S&P rating of AAA and convertible zero coupon bonds totaling \$4,701,462 with an S&P rating of BBB. The Police and Firemen's Mortgages and the Cash Management Fund are unrated.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Commercial paper must mature within 270 days. Certificates of deposits and bankers acceptances are limited to a term of one year or less. The maturity of repurchase agreements shall not exceed 15 days. The investment in a guaranteed income contract is limited to a term of 10 years or less.

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The following table summarizes the maturities (or, in the case of Remics, Police and Firemen's Mortgages and mortgage-backed securities, the expected average life) of the fixed income portfolio at June 30, 2006 and 2005:

<b>June 30, 2006 (000's)</b>	<b>Total</b>	<b>Maturities in Years</b>			
		<b>Less than 1</b>	<b>1-5</b>	<b>6-10</b>	<b>More than 10</b>
<b>Fixed Income Investment Type</b>	<b>Market Value</b>				
United States Treasury Notes	\$ 3,516,004	747,277	796,007	1,972,720	—
United States Treasury Bills	389,716	389,716	—	—	—
United States Treasury TIPS	790,555	—	60,532	580,319	149,704
United States Treasury Bonds	1,984,003	—	—	215,305	1,768,698
United States Treasury Strips	37,219	—	—	—	37,219
Title XI Merchant Marine Notes	3,615	—	—	—	3,615
Federal Agricultural Mortgage Corp. Notes	95,763	—	95,763	—	—
Federal Farm Credit Bank Bonds	50,270	—	50,270	—	—
Federal Home Loan Bank Bonds	466,312	175,074	268,104	23,134	—
Federal Home Loan Bank Discounted Notes	89,894	—	—	—	89,894
Federal Home Loan Mortgage Corp. Notes	341,897	322,470	—	19,427	—
Federal National Mortgage Association Notes	226,193	129,785	96,408	—	—
Resolution Funding Corp. Obligations	6,397	—	—	—	6,397
Floating Rate Notes	77,883	35,021	32,863	9,999	—
Corporate Obligations	4,926,894	712,831	1,267,070	1,126,601	1,820,392
Real Estate Investment Trust Obligations	93,436	—	42,914	50,522	—
Finance Company Debt	1,532,217	380,558	741,111	273,382	137,166
Supranational Obligations	75,512	—	—	—	75,512
International Bonds and Notes	327,494	124,499	145,353	18,137	39,505
Foreign Government Obligations	784,177	22,393	459,160	193,953	108,671
Remic/FHLMC	731,131	3,383	—	39,299	688,449
Remic/FNMA	67,108	1,321	—	17,827	47,960
Remic/GNMA	17,650	—	—	—	17,650
Police and Firemen's Mortgages	965,008	—	—	—	965,008
GNMA Mortgage Backed Certificates	78,051	12	637	—	77,402
FHLM Mortgage Backed Certificates	598,915	—	148	3,698	595,069
FNMA Mortgage Backed Certificates	620,790	149	9,291	21,177	590,173
Asset Backed Obligations	178,119	—	118,906	59,213	—
Private Export Obligations	55,971	—	11,887	44,084	—
	<u>\$ 19,128,194</u>	<u>3,044,489</u>	<u>4,196,424</u>	<u>4,668,797</u>	<u>7,218,484</u>

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<b>June 30, 2005 (000's)</b>	<b>Total Market Value</b>	<b>Maturities in Years</b>			
		<b>Less than 1</b>	<b>1-5</b>	<b>6-10</b>	<b>More than 10</b>
<b>Fixed Income Investment Type</b>					
United States Treasury Notes	\$ 1,813,358	111,930	795,152	906,276	—
United States Treasury TIPS	598,125	—	—	517,312	80,813
United States Treasury Bonds	2,193,224	—	—	—	2,193,224
United States Treasury Strips	42,326	—	—	—	42,326
Title XI Merchant Marine Notes	3,956	—	—	—	3,956
Federal Agricultural Mortgage Corp. Notes	101,698	—	101,698	—	—
Federal Farm Credit Bank Bonds	102,225	49,578	52,647	—	—
Federal Home Loan Bank Bonds	521,527	49,610	471,917	—	—
Federal Home Loan Bank Discounted Notes	4,244	—	—	—	4,244
Federal Home Loan Mortgage Corp. Notes	292,030	—	174,938	117,092	—
Federal National Mortgage Association Notes	724,402	226,752	315,835	26,078	155,737
Resolution Funding Corp. Obligations	7,337	—	—	—	7,337
Floating Rate Notes	77,922	—	67,923	9,999	—
Corporate Obligations	5,272,466	492,077	1,632,208	1,509,472	1,638,709
Real Estate Investment Trust Obligations	99,301	—	19,836	79,465	—
Finance Company Debt	2,138,535	405,222	1,021,737	576,593	134,983
Supranational Obligations	122,496	25,227	—	—	97,269
International Bonds and Notes	420,419	54,846	300,229	19,865	45,479
Foreign Government Obligations	1,654,211	45,065	632,606	567,437	409,103
Remic/FHLMC	638,865	—	9,872	20,959	608,034
Remic/FNMA	73,982	196	4,734	18,358	50,694
Remic/GNMA	17,993	—	—	—	17,993
Police and Firemen's Mortgages	896,707	—	—	—	896,707
GNMA Mortgage Backed Certificates	112,091	41	1,479	—	110,571
FHLM Mortgage Backed Certificates	774,802	—	265	4,999	769,538
FNMA Mortgage Backed Certificates	645,810	—	7,343	29,116	609,351
Asset Backed Obligations	252,973	—	153,828	34,509	64,636
Private Export Obligations	34,127	—	12,289	21,838	—
Convertible Zero Coupon Bonds	4,701	—	—	4,701	—
	<u>\$ 19,641,853</u>	<u>1,460,544</u>	<u>5,776,536</u>	<u>4,464,069</u>	<u>7,940,704</u>

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Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of an investment. The pension funds invest in global markets. The pension funds can invest in securities of companies incorporated in one of thirty countries approved by the Council. The market value of international preferred and common stocks and issues convertible into common stocks, when combined with the market value of international government and agency obligations, cannot exceed 22% of the market value of the pension funds. Not more than 5% of the value of the assets held by Common Fund D can be invested in companies incorporated in emerging market countries, and not more than 5% of the market value of the emerging market securities can be invested in any one corporation. Council regulations permit the pension funds to enter into foreign exchange contracts for the purpose of hedging the international portfolio. The pension funds held forward contracts totaling approximately \$1.9 billion and \$650 million at June 30, 2006 and 2005, respectively. Common Fund D had the following foreign currency exposure (expressed in U.S. dollars and 000's):

<b>June 30, 2006</b>			<b>Foreign</b>
<b>Currency</b>	<b>Total</b>	<b>Equities</b>	<b>Government</b>
<u>Currency</u>	<u>Market Value</u>	<u>Equities</u>	<u>Obligations</u>
Australian dollar	\$ 387,324	387,324	—
Canadian dollar	635,640	635,640	—
Danish krone	198,388	198,388	—
Euro	4,789,852	4,286,765	503,087
Hong Kong dollar	130,126	130,126	—
Japanese yen	3,039,675	3,039,675	—
Mexican peso	46,306	46,306	—
New Zealand dollar	18,426	18,426	—
Norwegian krone	269,692	269,692	—
Pound sterling	1,712,822	1,637,310	75,512
Singapore dollar	98,276	98,276	—
South Korean won	121,267	121,267	—
Swedish krona	760,561	682,104	78,457
Swiss franc	1,263,174	1,263,174	—
	<u>\$ 13,471,529</u>	<u>12,814,473</u>	<u>657,056</u>

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<b>June 30, 2005</b>			<b>Foreign</b>
<b>Currency</b>	<b>Total</b>		<b>Government</b>
	<b>Market Value</b>	<b>Equities</b>	<b>Obligations</b>
Australian dollar	\$ 401,419	272,432	128,987
Canadian dollar	587,693	502,887	84,806
Danish krone	148,396	148,396	—
Euro	4,447,970	3,646,096	801,874
Hong Kong dollar	167,809	167,809	—
Japanese yen	2,218,395	2,213,694	4,701
Mexican peso	40,732	40,732	—
New Zealand dollar	72,766	32,929	39,837
Norwegian krone	198,279	91,284	106,995
Pound sterling	2,181,965	1,957,489	224,476
Singapore dollar	75,678	75,678	—
South Korean won	141,633	141,633	—
Swedish krona	735,391	628,136	107,255
Swiss franc	1,017,524	1,017,524	—
	<u>\$ 12,435,650</u>	<u>10,936,719</u>	<u>1,498,931</u>

The Cash Management Fund is unrated. The Cash Management Fund is not evidenced by securities that exist in physical or book entry form held by the pension funds.

The pension funds' interests in alternative investments may contain elements of credit, currency and market risk. Such risks include, but are not limited to, limited liquidity, absence of regulatory oversight, dependence upon key individuals, emphasis on speculative investments (both derivatives and non-marketable investments), and nondisclosure of portfolio composition. Council regulations require that not more than 13 percent of the market value of the pension funds can be invested in alternative investments, with the individual categories of real assets, private equity and absolute return strategy investments limited to 5 percent, 7 percent and 5 percent of the market value, respectively. Not more than 5 percent of the market value of Common Fund E may be committed to any one partnership or investment, without the prior written approval of the Council. Common Fund E cannot own more than 25 percent of any individual investment. The investments in Common Fund E cannot comprise more than 20 percent of any one investment manager's total assets.

Net appreciation or depreciation in fair value of investments includes net realized gains and the change in net unrealized gains and losses on investments for the fiscal years ended June 30, 2006 and 2005. The net realized gain from investment transactions amounted to \$3,946,824,420 and the net increase in unrealized gains on investments amounted to \$567,526,008 for the year ended June 30, 2006. The net realized gain from investment transactions amounted to \$2,729,925,208 and the net increase in unrealized gains on investments amounted to \$935,762,205 for the year ended June 30, 2005.

**(4) SECURITIES LENDING COLLATERAL**

The System's share in the securities lending program is 21.19% and 21.27% of the total market value of the collateral as of June 30, 2006 and 2005, respectively.

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The securities lending collateral is subject to various risks. Among these risks are credit risk, concentration of credit risk and interest rate risk. Agreements with the lending agents require minimum credit ratings for certain categories of fixed income obligations and limit the amount that can be invested in any one issuer or issue as follows:

<u>Category</u>	<u>Minimum Rating</u>		<u>Limitation of Issuer's Outstanding Debt</u>	<u>Limitation of Issue</u>	<u>Other Limitations</u>
	<u>Moody's</u>	<u>S&amp;P</u>			
Corporate obligations	A3	A-	25%	25%	—
U.S. finance company debt and bank debentures	A2	A	10%	10%	—
Collateralized notes and mortgages	Aaa	AAA	—	33.3%	Limited to not more than 10% of the assets of the collateral portfolio
Commercial paper	P-1	A-1	—	—	Dollar limits by issuer
Certificates of deposit/ Banker's acceptances (rating applies to international)	Aa3/P-1	—	—	—	Uncollateralized cer- tificates of deposit and banker's acceptances' cannot exceed 10% of issuer's primary capital; dollar limits by issuer
Guaranteed income contracts	P-1	—	—	—	Limited to 5% of the assets of the col- lateral portfolio; A+ rating from A.M. Best for insurance companies
Money market funds	—	—	—	—	Limited to 10% of the assets of the collateral portfolio; limited to approved money market funds

Maturities of corporate obligations, U.S. finance company debt, bank debentures, collateralized notes and mortgages and guaranteed income contracts must be less than 25 months. Commercial paper maturities cannot exceed 270 days. Repurchase agreement maturities cannot exceed 15 days. Certificates of deposit and banker's acceptances must mature in one year or less.

The collateral for repurchase agreements is limited to obligations of the U.S. Government or certain U.S. Government agencies.

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Total exposure to any individual issuer is limited, except for U.S. Treasury and Government Agency Obligations. For money market funds, the total amount of shares or units purchased or acquired of any money market fund shall not exceed five percent of the shares or units outstanding of said money market fund. For Collateralized Notes and Mortgages, not more than two percent of the assets of the collateral portfolio shall be invested in the obligations of any one issuer. For Guaranteed Income Contracts, the total investment in any one issuer shall be limited to 2.5% of the collateral portfolio. The Division sets individual issuer limits for Commercial Paper and Certificate of Deposits. For Corporate Obligations, U.S. Finance Company Debt, Bank Debentures and Bankers Acceptances, exposure to any one issuer shall be limited to the following percentages of the collateral portfolio in accordance with the issuer's rating from Moody's: Aaa (4%), Aa (3%) and A (2%).

For securities exposed to credit risk in the collateral portfolio, the following tables disclose aggregate market value, by major credit quality rating category at June 30, 2006 and 2005. In those cases where an issuer and/or security have both a long-term and short-term rating, the short-term rating is disclosed.

**June 30, 2006**

(000's)

	<b>Moody's Rating</b>				
	<b>Aaa</b>	<b>Aa</b>	<b>A</b>	<b>P1</b>	<b>Not rated</b>
Corporate Obligations	\$ 699,376	3,602,027	1,611,461	—	—
Commercial Paper	—	—	—	3,683,532	—
Certificates of Deposit	1,957,748	—	—	—	—
Repurchase Agreements	—	—	—	—	1,609,375
Guaranteed Investment Contracts	—	450,000	—	—	—
Money Market Funds	253,861	—	—	—	101,392
Collateralized Notes	—	135,924	—	—	—
Cash	—	—	—	—	147
	<u>\$ 2,910,985</u>	<u>4,187,951</u>	<u>1,611,461</u>	<u>3,683,532</u>	<u>1,710,914</u>

**June 30, 2005**

(000's)

	<b>Moody's Rating</b>				<b>S&amp;P Rating (1)</b>
	<b>Aaa</b>	<b>Aa</b>	<b>A</b>	<b>P1</b>	<b>A</b>
Corporate Obligations	\$ 440,053	3,748,203	2,052,074	—	—
Commercial Paper	—	—	—	2,373,183	—
Certificates of Deposit	—	1,357,406	—	—	97,900
Repurchase Agreements	—	—	—	—	—
Guaranteed Investment Contracts	—	150,000	200,000	—	—
Money Market Funds	103,815	—	—	—	—
Collateralized Notes	10,000	—	—	—	—
	<u>\$ 553,868</u>	<u>5,255,609</u>	<u>2,252,074</u>	<u>2,373,183</u>	<u>97,900</u>

(1) Moody's rating not available

In addition, the collateral portfolio includes money market funds with a current market value of \$1,074,355 and repurchase agreements with a current market value of \$1,588,984,270 at June 30, 2005 which are not rated.

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POLICE AND FIREMEN'S RETIREMENT SYSTEM**

Notes to Financial Statements

June 30, 2006 and 2005

The following tables summarize the maturities of the collateral portfolio at June 30, 2006 and 2005.

<b>June 30, 2006 (000's)</b>	<b>Total Market Value</b>	<b>Maturities</b>	
		<b>Less than one year</b>	<b>One year to 25 months</b>
Corporate Obligations	\$ 5,912,864	2,301,117	3,611,747
Commercial Paper	3,683,531	3,683,531	—
Certificates of Deposit	1,957,748	1,957,748	—
Repurchase Agreements	1,609,375	1,609,375	—
Guaranteed Investment Contracts	450,000	350,000	100,000
Money Market Funds	355,253	355,253	—
Collateralized Notes	135,924	—	135,924
	<u>\$ 14,104,695</u>	<u>10,257,024</u>	<u>3,847,671</u>

<b>June 30, 2005 (000's)</b>	<b>Total Market Value</b>	<b>Maturities</b>	
		<b>Less than one year</b>	<b>One year to 25 months</b>
Corporate Obligations	\$ 6,240,331	4,753,161	1,487,170
Commercial Paper	2,373,183	2,373,183	—
Certificates of Deposit	1,455,306	1,455,306	—
Repurchase Agreements	1,588,984	1,588,984	—
Guaranteed Investment Contracts	350,000	250,000	100,000
Money Market Funds	104,889	104,889	—
Collateralized Notes	10,000	10,000	—
	<u>\$ 12,122,693</u>	<u>10,535,523</u>	<u>1,587,170</u>

As of June 30, 2006, the pension funds had received cash collateral of \$14,115,678,308 for outstanding loaned investment securities having market values of \$13,824,349,093. As of June 30, 2005, the pension funds had received cash collateral of \$12,166,888,240 for outstanding loaned investment securities having market values of \$11,780,098,612. In addition, as of June 30, 2006, the pension funds loaned investment securities having market values of \$1,471,340, against which it had received non cash collateral with a current value of \$1,494,859, which is not reflected in the accompanying financial statements. As of June 30, 2005, the pension funds loaned investment securities having market values of \$38,245,996, against which it had received non cash collateral with a current value of \$39,118,460, which is not reflected in the accompanying financial statements.

**STATE OF NEW JERSEY  
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Notes to Financial Statements

June 30, 2006 and 2005

**(5) CONTRIBUTIONS**

The contribution policy is set by N.J.S.A. 43:16A and requires contributions by active members and contributing employers. Plan member and employer contributions may be amended by State of New Jersey legislation. Employers are required to contribute at an actuarially determined rate. The annual employer contributions include funding for basic retirement allowances, cost-of-living adjustments, and noncontributory death benefits. Members contribute at a uniform rate of 8.5% of base salary.

For fiscal year 2006, the 50% of any available excess valuation assets could be utilized to offset normal contributions. Thereafter, a certain percentage of available excess valuation assets may be used as specified in the legislation. The normal contribution for basic pension benefits, noncontributory death benefits, and cost-of-living adjustments was funded by excess valuation assets in accordance with Chapter 115, P.L. 1997. This legislation provides for actuarially determined excess valuation assets to offset the required normal contributions of the State of New Jersey and the local participating employers.

Since fiscal year 2005, there have been no excess valuation assets to fund the required State contributions.

In accordance with legislation passed in 2001 (Chapter 44, P.L. 2001), excess valuation assets were recognized to reduce 2001 local employer contributions by \$150 million to approximately \$75 million. This legislation required that the savings realized by counties and municipalities as a result of this reduction be used for property tax relief.

Chapter 108, P.L. 2003, effective July 1, 2003, provided that local employer PFRS normal and accrued liability contributions will be 20% of the amount certified by the PFRS for payments due in State fiscal year 2004 and thereafter a percentage of the amount certified by the System as the State Treasurer will determine, but not more than 40% in fiscal year 2005, not more than 60% in fiscal year 2006, and not more than 80% in fiscal year 2007.

The State made a contribution of \$73.54 million for fiscal year 2006 pension obligation. According to the Appropriation Act of 2003 related to fiscal year 2006, the State is paying pension obligations through a five-year phase-in.

**(6) FUNDS**

This System maintains the following legally required funds:

**Members' Annuity Savings Fund (2006-\$2,548,345,093; 2005-\$2,399,046,135)**

The Members' Annuity Savings Fund (ASF) is credited with all contributions made by active members of the System.

**Retirement Reserve Fund (2006-\$8,869,250,998; 2005-\$8,481,386,767)**

The Retirement Reserve Fund is the account from which retirement benefits other than life insurance premiums, including cost-of-living benefits, are paid. Upon retirement of a member, accumulated contributions are transferred to the Retirement Reserve Fund from the Members' ASF. Any additional reserves needed to fund the balance of the retirement benefit are transferred from the Pension Accumulation Fund. Annually, interest as determined by the State Treasurer (8.25% for fiscal year 2006; 8.75% for 2005) is credited to the Retirement Reserve Fund.

**Special Reserve Fund (2006-\$172,436,265; 2005-\$315,555,099)**

The Special Reserve Fund is a fund to which any excess earnings and gains from sales and maturities of investments are transferred and against which any losses from the sales of securities are charged. The maximum limit on the accumulation of this account is 1% of the market value of the investments of the System. Amounts in excess of 1% are credited to the Pension Accumulation Fund.

**STATE OF NEW JERSEY  
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Notes to Financial Statements

June 30, 2006 and 2005

**Pension Accumulation Fund (2006-\$7,335,154,301; 2005-\$6,213,991,350)**

The Pension Accumulation Fund is credited with the contributions of the State of New Jersey and other employers. Interest earnings, after crediting the ASF and the Retirement Reserve Fund, as required, are credited to this account. Additionally, payments for life insurance premiums are made from this Fund.

**(7) INCOME TAX STATUS**

Based on a 1986 declaration of the Attorney General of the State of New Jersey, the System is a qualified plan as described in Section 401(a) of the Internal Revenue Code.

**STATE OF NEW JERSEY  
POLICE AND FIREMEN'S RETIREMENT SYSTEM**

Required Supplementary Information (Unaudited)

Schedule of Funding Progress

ACTUARIAL VALUATION DATE	ACTUARIAL VALUE OF ASSETS (a)	ACTUARIAL ACCRUED LIABILITY (b)	UNFUNDED (OVERFUNDED) ACTUARIAL ACCRUED LIABILITY (b - a)	FUNDED RATIO (a / b)	COVERED PAYROLL (c)	UNFUNDED (OVERFUNDED) ACTUARIAL ACCRUED LIABILITY AS A PERCENTAGE OF COVERED PAYROLL (b - a) / c
<b>State</b>						
June 30, 1997	\$1,183,747,522	\$1,234,959,165	\$51,211,643	95.9%	\$315,690,310	16.2%
June 30, 1998	1,559,131,933	1,377,734,455	(181,397,478) <sup>(1)</sup>	113.2%	346,079,078	(52.4%)
June 30, 1999	1,717,248,151	1,534,470,501	(182,777,650) <sup>(1)</sup>	111.9%	362,949,950	(50.4%)
June 30, 2000	1,884,870,936	1,666,842,906	(218,028,030)	113.1%	363,360,250	(60.0%)
June 30, 2001	1,991,299,968	1,866,140,391	(125,159,577)	106.7%	398,118,379	(31.4%)
June 30, 2002	2,032,977,241	2,046,820,189	13,842,948	99.3%	418,849,259	3.3%
June 30, 2003	1,907,752,767	2,330,909,918	423,157,151	81.8%	447,470,022	94.6%
June 30, 2004	1,940,936,459	2,509,192,584	568,256,125	77.4%	450,406,301	126.2%
June 30, 2005	2,005,752,079	2,815,620,221	809,868,142	71.2%	482,460,402	167.9%
<b>Local</b>						
June 30, 1997	10,854,173,290	11,746,169,752	891,996,462	92.4%	1,767,762,346	50.5%
June 30, 1998	13,169,957,658	12,881,842,367	(288,115,291) <sup>(1)</sup>	102.2%	1,870,322,787	(15.4%)
June 30, 1999	14,536,570,357	13,894,951,617	(641,618,740) <sup>(1)</sup>	104.6%	1,971,087,124	(32.6%)
June 30, 2000	15,644,750,281	14,924,699,712	(720,050,569)	104.8%	2,055,781,766	(35.0%)
June 30, 2001	16,083,153,842	16,056,446,646	(26,707,196) <sup>(2)</sup>	100.2%	2,163,590,060	(1.2%)
June 30, 2002	16,392,195,411	17,181,142,310	788,946,899	95.4%	2,275,130,620	34.7%
June 30, 2003	16,447,380,691	18,422,073,072	1,974,692,381 <sup>(3)</sup>	89.3%	2,393,467,444	82.5%
June 30, 2004	16,762,453,668	19,769,046,766	3,006,593,098	84.8%	2,524,859,162	119.1%
June 30, 2005	17,372,138,294	21,388,972,326	4,016,834,032	81.2%	2,619,347,468	153.4%

**Notes to Schedule**

- (1) Adjusted to reflect the impact of legislation passed in fiscal year 2002 which retroactively affected the June 30, 1999 and 1998 valuations. Chapter 4, P.L. 2001 provides benefit enhancements for certain eligible members who retired prior to December 29, 1989. The unfunded accrued liability attributable to the increased benefits was exactly offset by the recognition of an additional amount of market value of assets in the determination of the actuarial value of assets for the July 1, 1999 valuation.
- (2) Chapter 44, P.L. 2001, referred to in Note 5, reduced the contribution of local employers by \$150 million.
- (3) The original June 30, 2003 valuation was revised due to the change in economic assumptions which would affect the fiscal year 2006 employer contributions and due to the impact of the Appropriation Act for fiscal year 2005 which reduced the State contribution rate from the original 40% to 30% of the statutory required contribution.

**STATE OF NEW JERSEY**  
**POLICE AND FIREMEN'S RETIREMENT SYSTEM**

Required Supplementary Information (Unaudited)

Schedule of Funding Progress - Additional Actuarial Information

Significant actuarial methods and assumptions used in the most recent June 30, 2005 and 2004 actuarial valuations included the following:

	June 30, 2005	June 30, 2004
Actuarial cost method	Projected unit credit	Projected unit credit
Asset valuation method	5 year average of market value	5 year average of market value
Amortization method	Level percent, closed	Level percent, closed
Remaining amortization period	30 years	30 years
Actuarial assumptions:		
Interest rate	8.25%	8.25%
Salary range	7.20%	5.95%
Cost-of-living adjustments	1.80%	1.80%

The actuarial assumptions used in the June 30, 2005 and 2004 valuations reflect the actuarial assumptions developed from the three year experience investigation for the period ending June 30, 2004.

Annual covered payroll is an estimate based upon annualizing one quarter's actual payroll.

**STATE OF NEW JERSEY  
POLICE AND FIREMEN'S RETIREMENT SYSTEM**

Required Supplementary Information (Unaudited)

Schedule of Employer Contributions

<b>YEAR ENDED JUNE 30,</b>	<b>ANNUAL REQUIRED CONTRIBUTION</b>	<b>EMPLOYER CONTRIBUTIONS<sup>(1)</sup></b>	<b>PERCENTAGE CONTRIBUTED</b>
<b>State</b>			
1997	\$111,775,028	\$715,344,385 <sup>(2)</sup>	640.0%
1998	84,167,834	73,587,848 <sup>(3)</sup>	87.4%
1999	93,920,617	23,730,087 <sup>(3)</sup>	25.3%
2000	98,974,449	60,521,749 <sup>(3)</sup>	61.1%
2001	95,883,272	— <sup>(3)</sup>	0.0%
2002	103,580,989	— <sup>(3)</sup>	0.0%
2003	104,998,547	— <sup>(3)</sup>	0.0%
2004	118,297,232	22,215,429 <sup>(3)(4)</sup>	18.8%
2005	161,455,508	49,326,846 <sup>(4)</sup>	30.6%
2006	200,902,193	73,541,000 <sup>(4)</sup>	36.6%
<b>Local</b>			
1997	250,220,580	234,963,865	93.9%
1998	238,002,765	223,491,008	93.9%
1999	273,210,113	256,551,862	93.9%
2000	275,790,739	214,164,848	77.7%
2001	249,746,232	75,670,018	30.3%
2002	248,754,078	185,415 <sup>(3)</sup>	0.1%
2003	259,969,532	364,850 <sup>(3)</sup>	0.1%
2004	316,272,883	53,396,685 <sup>(5)</sup>	16.9%
2005	355,229,715	132,740,650 <sup>(5)</sup>	37.4%
2006	475,872,193	260,986,583 <sup>(5)</sup>	54.8%

**Notes to Schedule**

- (1) Local employer contributions include contributions made by the State to provide funding for certain benefits payable to local participants.
- (2) For the year ended June 30, 1997, the state portion of employer contributions exceeded the annual required contributions as a result of legislation that was enacted (Chapter 114, P.L. 1997), authorizing the New Jersey Economic Development Authority to issue bonds, notes or other obligations for the purpose of financing, in full or in part, the State of New Jersey's portion of the unfunded accrued liability under the State of New Jersey retirement systems.
- (3) In accordance with Chapter 115, P.L. 1997, all or a portion of the required contribution was funded by available excess valuation assets.
- (4) In accordance with the provisions of the Appropriation Act for fiscal years 2004 through 2006, the State statutory required contributions have been reduced.
- (5) In accordance with Chapter 108, P.L. 2003, the local statutory required contributions for fiscal years 2004 through 2006 have been reduced.

**STATE OF NEW JERSEY  
POLICE AND FIREMEN'S RETIREMENT SYSTEM**

Schedule of Changes in Fiduciary Net Assets by Fund

Year ended June 30, 2006

	<b>MEMBERS' ANNUITY SAVINGS FUND</b>	<b>PENSION ACCUMULATION FUND</b>	<b>RETIREMENT RESERVE FUND</b>	<b>SPECIAL RESERVE FUND</b>	<b>TOTAL</b>
<b>Additions:</b>					
Contributions:					
Members	\$ 290,681,716	—	—	—	290,681,716
Employers	—	714,210,999	—	—	714,210,999
Total contributions	290,681,716	714,210,999	—	—	1,004,892,715
Distribution of net investment income	—	975,666,528	699,714,408	—	1,675,380,936
Total additions	290,681,716	1,689,877,527	699,714,408	—	2,680,273,651
<b>Deductions:</b>					
Benefits	—	31,695,612	1,121,795,183	—	1,153,490,795
Refunds of contributions	6,571,800	72,942	—	—	6,644,742
Administrative expenses	—	4,930,808	—	—	4,930,808
Total deductions	6,571,800	36,699,362	1,121,795,183	—	1,165,066,345
Net increase (decrease) before transfers among reserves	284,109,916	1,653,178,165	(422,080,775)	—	1,515,207,306
Transfers among reserves:					
Retirements	(137,187,994)	(687,665,208)	824,853,202	—	—
Other	2,377,036	155,649,994	(14,908,196)	(143,118,834)	—
Net increase	149,298,958	1,121,162,951	387,864,231	(143,118,834)	1,515,207,306
Net assets held in trust for pension benefits:					
Beginning of year	2,399,046,135	6,213,991,350	8,481,386,767	315,555,099	17,409,979,351
End of year	\$ 2,548,345,093	7,335,154,301	8,869,250,998	172,436,265	18,925,186,657