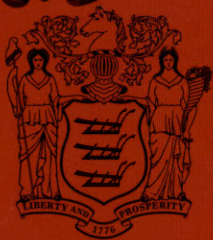


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**STATE INVESTMENT COUNCIL  
DEPARTMENT OF THE TREASURY  
STATE OF NEW JERSEY**

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**FIFTY-THIRD ANNUAL REPORT**

**For the Fiscal Year Ended June 30, 2003**



JAMES E. McGREEVEY  
Governor



JOHN E. McCORMAC, CPA  
State Treasurer

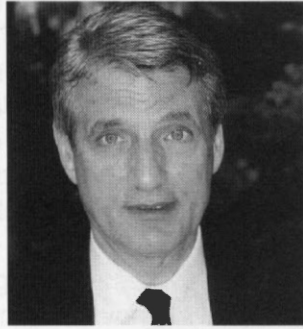
A Report to  
Governor James E. McGreevey  
the Members of the  
New Jersey Legislature  
and the State Treasurer

Submitted by the  
State Investment Council

For the Fiscal Year ended June 30, 2003



# The State Investment Council



ORIN S. KRAMER  
Chair of the Council



JOHN K. SAYERS  
State Police Retirement  
System Representative;  
Vice Chair of the Council



SUSAN A. CROTTY



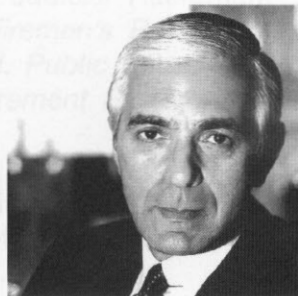
JAMES M. FARRELL, ESQ.



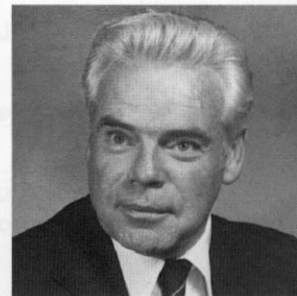
CHERYL A. MILLS



DR. DOUGLAS A. LOVE



ANTHONY TERRACCIANO



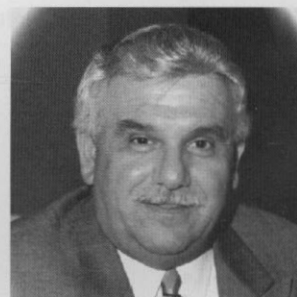
HARRY W. BALDWIN  
Teachers' Pension and  
Annuity Fund



SUZANNA M.F.  
BURIANI-DeSANTIS  
Public Employees'  
Retirement System



GEORGE A. CASTRO II  
Consolidated Police &  
Firemen's Pension Fund



VINCENT FOTI  
Police & Firemen's  
Retirement System

# Division of Investment



PETER A. LANGERMAN  
Director



WILLIAM G. CLARK  
Deputy Director

JAMES E. McGRIFF  
Governor



HARRY W. BALDWIN  
Treasurer, Pension and  
Annuity Fund

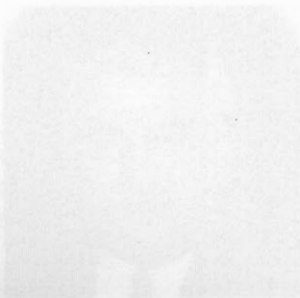


ANTHONY TERRACIANO



DR. DOUGLAS A. LOVE

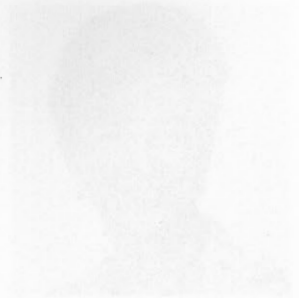
A Report to  
Governor James E.  
McGriff from the  
Members of the  
New Jersey State  
Retirement System  
and the State  
Employees' Retirement  
System



VINCENT FORT  
Police & Fire  
Retirement System



GEORGE A. CASTRO II  
Consolidated Police &  
Firemen's Pension Fund



SUZANNE M. R.  
DURAND-DESANTIS  
Public Employees'  
Retirement System



After two years of negative investment returns, we are pleased to report that the assets supporting the various pension plans sponsored by the State of New Jersey had positive investment performance of 3.3% for the fiscal year ending June 30, 2003. Total pension fund net assets supporting these seven defined benefit pension systems (the "Pension Fund Composite") declined slightly from \$63.3 billion at June 30, 2002 to \$62.6 billion at June 30, 2003. This decline was primarily attributable to net pension fund withdrawals of \$2.6 billion during the year.

Total net assets managed by the New Jersey Division of Investment (the "Division"), a division within the Department of the Treasury, were \$76.5 billion as of June 30, 2003. These assets consist of the seven pension systems noted above along with approximately 175 other State funds and more than 1,130 "other-than-State" funds managed by the Division. The majority of these other funds are invested in the State of New Jersey's Cash Management Fund, with the remainder consisting primarily of funds for the State's Deferred Compensation (457) Plan and the Supplemental Annuity Collective Trust (a 403(b) plan).

### **Overview**

The Division is responsible for the investment of the assets of seven pension funds. The funds include: *Consolidated Police and Firemen's Pension Fund*, *Judicial Retirement System of New Jersey*, *Police and Firemen's Retirement System*, *Prison Officers Pension Fund*, *Public Employees' Retirement System*, *State Police Retirement System*, and *Teachers' Pension and Annuity Fund*.

The Division invests in domestic and international equities and fixed income and is run by a sixty-five person staff.

*Copies of the pension fund portfolios are on file at the Division of Investment and are available upon request.*

<sup>(1)</sup> Includes \$3,964,787 held for Pension, NJBEST, DCP, SACT, and Trustees Funds

### **Assets Under Management— June 30, 2003 (000s omitted)**

Consolidated Police & Firemen's Pension Fund	\$18,537
Judicial Retirement System	\$300,831
Police & Firemen's Retirement System	\$14,156,912
Prison Officers Pension Fund	\$17,348
Public Employees' Retirement System	\$20,317,812
State Police Retirement System	\$1,520,113
Teachers' Pension & Annuity Fund	\$26,236,101
<b>Total Pension Fund Assets</b>	<b>\$62,567,654</b>
Cash Management <sup>(1)</sup>	\$16,165,234
NJBEST	\$178,737
Deferred Compensation Plan	\$1,133,047
Supplemental Annuity Collective Trust	\$129,141
Trustees	\$96,029
Other	\$161,054
<b>Total Assets Under Management</b>	<b>\$76,466,109</b>

## **Division Management**

Director—Peter A. Langerman

Deputy Director—William G. Clark

Assistant Director—Gilles Michel

Investment Officer—Maneck Kotwal

Chief of Staff—Amanda Ignatowitz

Compliance Officer & Middle Office Manager—  
Susan Sarnowski

Trading Officer—Michael Wszolek

Manager of International Accounting—Mary Vassiliou

Manager of Domestic Accounting—Patricia Schwartz

Manager, Fiscal Resources—Kenneth Scott

Fund Cashier—John Giovannetti

## **Investment Managers**

### **Domestic Equities**

Brian Arena

Elizabeth Carr

Karin Hollinger

Jeff Lebowitz

Sharon Montalto

Thomas Montalto

Edward Pittman

Michael Sawyer

### **International**

Kersti Alabert

Victor Mostrowski

Vitaly Smirnov

Bruce Smith

### **Domestic Fixed Income**

Linda Brooks

Timothy Patton

## **Division Staff**

Nancy Brancolino

Celeste Brennan

Edward Burns

Cynthia Caporale-Kroes

Ellie Chiaramonti

Kass Cole

Melissa Cook

Christine Eckel

Cynthia Everett

Linda Gaspari

Jeffrey Grossman

Olga Grozio

Ron Hentrik

Lori Hillman

Sandra Holmes

Patricia Hricak

Manick Jhingade

Rosetta Muccie

Kevin Onderdonk

Valerie Oscilowski

Vincent Pagnotta

Krystal Paquette

Arlene Patel

John Penza

Bart Pericoloso

Angel Rodriguez

Heather Rodriguez

Roberto Rosati

Catherine Ryan

Danielle Scholl

Robert Schragger

Sharon Scully

Mary Ann Smith

Donald Sward

Andrea Szul

Jeffrey Taylor

Linda Thompson

William Trent

Roxanne Tyner

James Vandervort

Vivian Velenger

Prity Vyas

Kathleen Warchol

Joanne Yakelewicz

## **State Investment Council**

The State Investment Council (the "Council") meets monthly to discuss major investment policy issues and to review the investment programs and returns of each fund.

The objective of the investment policies of the Council is, "consistent with the preservation of capital, to achieve high long-term average total returns subject to prudent, diversified investment risk."

- 11 member Council
  - 5 members are appointed by the Governor with the advice and consent of the State Senate, 1 member appointed jointly by the President of the Senate and Speaker of the General Assembly
  - 5 State Retirement Systems are represented by members appointed by the following boards
    - Teachers' Pension and Annuity Fund
    - Consolidated Police and Firemen's Pension Fund
    - Public Employees' Retirement System
    - Police and Firemen's Retirement System
    - State Police Retirement System

## **The Council At a Glance...\***

**Orin S. Kramer, Chair**  
Gubernatorial Appointee

**John K. Sayers, Vice Chair**  
State Police Retirement System

**Harry W. Baldwin**  
Teachers' Pension and Annuity Fund

**Suzanna Buriani-DeSantis**  
Public Employees' Retirement System

**George A. Castro II**  
Consolidated Police & Firemen's Pension Fund

**Susan Ann Crotty**  
Gubernatorial Appointee

**James M. Farrell, Esq.**  
Gubernatorial Appointee

**Vincent Foti**  
Police and Firemen's Retirement System

**Dr. Douglas A. Love**  
Gubernatorial Appointee

**Cheryl A. Mills**  
Gubernatorial Appointee

**Anthony Terracciano**  
Gubernatorial Appointee

*\* As of September 30, 2003*



# The Council

## At a Glance

One of the Council's primary responsibilities is to review and approve the investment policy and to monitor the investment performance and returns of the fund.

John K. Sawyer, Vice Chair  
State Police Retirement System

Harry W. Hildreth  
Public Employees Retirement System

Suzanne E. Smith, Secretary  
Public Employees Retirement System

George A. Goss, Treasurer  
Public Employees Retirement System

Gwen Ann O'Leary  
Public Employees Retirement System

James M. Farrell, Esq.  
Public Employees Retirement System

Dr. Douglas A. Love  
Public Employees Retirement System

Cheryl A. Mills  
Public Employees Retirement System

Anthony J. Tennant  
Public Employees Retirement System

As of September 30, 2003

# State Investment Council

## At a Glance

The State Investment Council is the Council's primary responsibility is to review and approve the investment policy and to monitor the investment performance and returns of the fund.

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## **Summary of Financial Markets During the Fiscal Year**

The global financial markets entered the fiscal year after experiencing two years of significant losses for both domestic and international equities. Equity returns during this period were negatively impacted by two major factors: the unwinding of the excessive gains realized in the late 1990's and the lasting economic impact of the September 11, 2001 terrorist attacks on New York and Washington, D.C. During this two-year period, the S&P 500 Index (an index of domestic equity securities) and the MSCI EAFE International Index (an index of international equity securities) declined by 30.1% and 30.7%, respectively.

Conversely, returns on fixed income securities realized during the two preceding years were strong, aided by sub-par economic growth, low inflation and an accommodative posture by the Federal Reserve Bank. The Lehman U.S. Government/Credit Index, a proxy for the domestic fixed income market, generated a positive return of 20.2% during this two-year period.

The global financial markets continued these trends for most of the current fiscal year as well, as economic growth remained weak and the prospect of a war in Iraq weighed on the equity markets. Returns on domestic and international equities were again negative for the first nine months of the current fiscal year, and interest rates continued to decline (for example, the yield on the 10-year U.S. Treasury fell from 4.46% as of June 30, 2002 to 3.37% as of May 31, 2003).

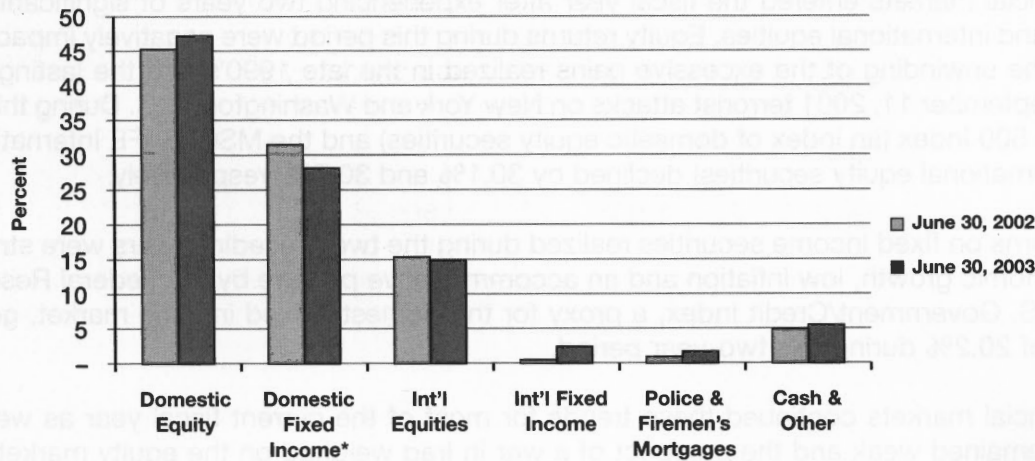
The financial markets staged a dramatic turnaround in the quarter ending June 30, 2003, however, as (1) combat operations in Iraq reached a successful conclusion, (2) the Federal Reserve lowered the federal funds rate again, bringing the rate down to 1%, and (3) the projected budget deficit widened significantly given the effects of tax cuts and increased spending on post-war Iraq and other programs. Equities then began to "price in" an economic recovery, and realized significant gains during the April-June quarter, with the S&P 500 and the MSCI EAFE International Indices gaining 15.4% and 19.6%, respectively.

## **Investment Activity**

As previously stated, total pension fund net assets declined from \$63.3 billion to \$62.6 billion during the fiscal year. Net pension fund withdrawals (i.e., direct payments to beneficiaries and other pension plan withdrawals offset by state and local government and employee contributions) were \$2.6 billion during the year. Net investment returns (including interest and dividends, securities lending income, realized gains and losses, and the change in unrealized gains and losses on investment securities) amounted to positive \$1.9 billion. During the year, securities purchased and sold for the pension funds amounted to \$18.5 billion and \$19.4 billion, respectively. Commissions paid for all funds managed by the Division were approximately \$31.7 million, which included \$2.6 million directed to pay for research and access to various economic and financial databases.

The following bar graph details the changes in asset allocation of the pension fund net assets over the course of the fiscal year.

## Pension Fund Composite Asset Allocation



\*Includes Mortgage-Backed Securities

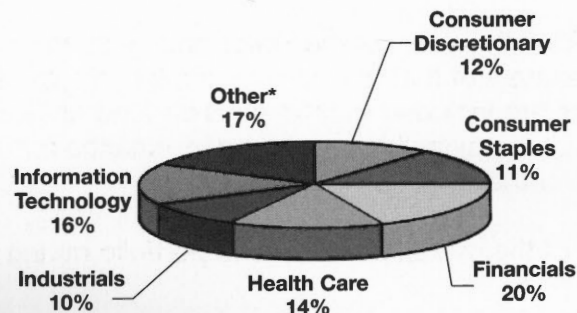
### Domestic Equities

The percentage of the portfolio invested in domestic equity securities increased from 45.1% to 46.9% over the course of the fiscal year. This increase is primarily attributable to asset allocation shifts into domestic equities of approximately \$1.2 billion made by the Division throughout the year.

Common Pension Fund A (the commingled domestic equity portfolio for the pension funds) had an investment return of negative 0.1% for the year, versus a flat S&P Composite 1500 Index (the "benchmark" domestic equity index established by the Council for our domestic equity portfolio).

As shown below, the portfolio is broadly diversified by economic sector. While the exposure to most sectors and industries is comparable to that of the overall market, the portfolio maintains "overweight" positions (i.e., exposure that exceeds that of the overall market in percentage terms) in the Oil and Gas and Pharmaceutical industries. For Oil and Gas, we believe that the supply/demand situation for energy—particularly natural gas—will remain favorable for these companies for many years to come. With respect to pharmaceutical companies, we believe that the valuation of many of these stocks remains attractive relative to their anticipated long-term growth rates.

### Pension Fund Domestic Equity Portfolio Allocation by Economic Sector



\*Includes: Energy; Materials; Telecommunications Services and Utilities



## **Domestic Fixed Income**

The percentage of the portfolio invested in domestic fixed income securities (excluding mortgage-backed securities) declined from 28.2% to 24.6% during the fiscal year. Even though the portfolio realized a positive return of 13.1% for the year, the Division transferred approximately \$2.0 billion out of the portfolio during the year to fund net benefits and the additional investment in domestic equities noted above.

The performance of Common Pension Fund B (the commingled domestic fixed income portfolio for the pension funds) of 13.1%, was equal to the return on the Lehman U.S. Government/Credit Index, the benchmark selected by the Council for the domestic fixed income portfolio. As of June 30, 2003, the portfolio duration on the domestic fixed income portfolio was approximately 5.29 years versus 5.58 years for the Lehman U.S. Government/Credit Index.

## **International**

The overall international portfolio, Common Pension Fund D (consisting of equity and fixed income securities for the pension funds), increased from 16.5% of the portfolio to 18.9% during the fiscal year. Within the international portfolio, however, international equities declined from 15.5% to 14.9% of the total portfolio during the year, while international fixed income increased from 1.0% to 4.0%.

The increase in international fixed income is attributable to the strong performance of the portfolio relative to other asset classes and the additional investment of \$400 million into international fixed income securities made by the Division during the fiscal year. These investments were driven by our view that the U.S. dollar would decline in value and that foreign bond markets would outperform the U.S. market.

Overall performance of the international portfolio was negative 5.4% for the year versus negative 6.5% for the MSCI EAFE International Index (the benchmark for the international portfolio selected by the Council).

## **Mortgage-Backed Securities**

The mortgage-backed securities portfolio, consisting of mortgage-back securities issued and guaranteed by agencies of the United States Government, declined from 3.6% to 2.0% during the fiscal year. We did not add to the mortgage-backed securities portfolio during the year, and the portfolio realized significant prepayments resulting from the decline in mortgage interest rates available in the market.

## **Police and Fire Mortgage Program**

New Jersey law provides that up to 10 percent of the Police and Firemen's Retirement System assets may be made available to eligible members of that pension system for mortgage loans with interest rates that are set by formula. These assets are included in total pension fund assets, but the performance of this portfolio is not included as part of the overall investment performance for the pension funds since these assets are not under the control of the Division.

This portfolio remained at 1.5% of the overall pension fund portfolio during the fiscal year.

## Cash Management Fund

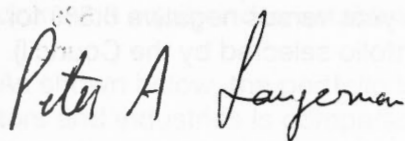
The pension fund's balance within the Cash Management Fund increased from 5.0% to 6.0% of the total portfolio during the fiscal year. The yield on the Cash Management Fund for State Participants as of June 30, 2003 was 1.9%, which was in line with short-term interest rates available in the marketplace.

This past fiscal year has also seen a number of important developments at the Division. At the end of 2002, the State Treasurer engaged an outside consulting firm to review the Division's operations and investment policies, and the report was presented to the Council in September 2003. The report contained a host of recommendations and, as noted in the report, many of them had been identified and were already being implemented by the Division and the Council.

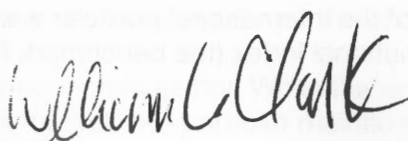
Among the most significant of the recommendations was that the pension funds be invested in a more diversified fashion, beyond the stocks and fixed income securities that currently comprise the investment portfolio. Increased diversification would, according to the report, further the objectives of increasing expected returns from the portfolio while reducing expected risk. Such diversification would take the form of so-called "alternative investments" that could include asset classes such as real estate, private equity and high yield bonds. The report also recommended the retention of an outside consultant to assist the Council in formulating its specific asset allocation decisions.

The Council and Division are continuing their review of the report and its recommendations, and further action in this regard will be forthcoming.

We hope that this letter, along with the accompanying financial statements and other information contained in this Annual Report, provides you with an overview of the investment portfolio supporting the major pension systems maintained by the State of New Jersey.



Peter A. Langerman  
Director



William G. Clark  
Deputy Director

# FIVE YEAR SUMMARY

Fiscal Year Ended June 30,

5-Year Annualized  
Return for period ended  
June 30, 2003

1999 2000 2001 2002 2003  
\$ Millions

## FUNDS UNDER THE SUPERVISION OF THE STATE INVESTMENT COUNCIL:

### Fair (or Market) Value:

Pension Funds	\$ 76,230	\$ 82,553	\$ 72,166	\$ 63,318	\$ 62,568
All Funds	86,246	94,064	83,632	72,674	76,466

### Fair (or Market) Value of Pension Funds

#### by Category:

Short-term obligations	\$ 4,424	\$ 3,801	\$ 3,299	\$ 3,120	\$ 3,705
Long-term bonds	18,954	19,366	20,160	18,595	17,857
Mortgages	3,499	4,488	3,716	3,157	2,190
Stocks	49,338	54,871	45,258	38,459	38,523
Other (1)	15	27	(267)	(13)	293
Total	<u>\$ 76,230</u>	<u>\$ 82,553</u>	<u>\$ 72,166</u>	<u>\$ 63,318</u>	<u>\$ 62,568</u>

### Investment Income:

Pension Funds					
Net Income and Realized Gains (Losses)	\$ 4,598	\$ 3,814	\$ 2,732	\$ 2,038	\$ 793
Unrealized Appreciation (Depreciation)	5,632	4,906	(10,670)	(7,996)	1,123
Total	<u>\$ 10,230</u>	<u>\$ 8,720</u>	<u>\$ (7,938)</u>	<u>\$ (5,958)</u>	<u>\$ 1,916</u>

### All Funds

Net Income and Realized Gains (Losses)	\$ 5,060	\$ 4,372	\$ 3,339	\$ 2,369	\$ 1,101
Unrealized Appreciation (Depreciation)	5,791	4,955	(10,866)	(8,172)	1,123
Total	<u>\$ 10,851</u>	<u>\$ 9,327</u>	<u>\$ (7,527)</u>	<u>\$ (5,803)</u>	<u>\$ 2,224</u>

### Total Rate of Return: (2)

All Pension Funds (2)	16.0%	12.0%	-10.4%	-9.0%	3.3%	1.8%
Common Pension Fund A (3)	27.4	12.3	-16.1	-20.3	-0.1	-0.9
Common Pension Fund B (3)	2.8	4.3	10.9	9.2	13.1	8.0
Common Pension Fund D (3)	4.9	21.1	-24.5	-6.8	-5.4	-3.3

### Returns of Various Market Indices:

S&P Composite 1500 Index	21.4%	8.1%	-12.8%	-16.5%	0.0%	-0.9%
S&P 500 Index	22.8	7.3	-14.8	-18.0	0.3	-1.6
Dow Jones Industrial Average	24.6	-3.3	-4.5	-10.3	-0.2	0.6
Lehman U.S. Government/Credit Index	2.8	4.3	11.1	8.2	13.1	7.9
Lehman Mortgage Index	4.0	5.0	10.5	9.0	5.7	6.8
MSCI EAFE International Stock Index	7.7	17.1	-23.8	-9.0	-6.5	-3.9

### State of New Jersey Cash Management Fund:

Book Value of Units of Participation:					
All Participants	\$ 14,157	\$ 13,811	\$ 13,408	\$ 11,105	\$ 16,165
Other-than-State Participants	3,804	3,958	4,647	4,924	7,740

### Average Annualized Compounded Rate of Return:

State Participants	5.4%	5.8%	6.2%	3.1%	1.9%	4.5%
3-Month Treasury Bills	4.7%	5.3%	5.6%	2.7%	1.4%	3.9%

### Number of Funds Under the Supervision of the

State Investment Council	160	169	178	181	182
Total Number of Transactions	48,883	52,465	49,557	51,069	49,423

1. Other represents adjustments to the net asset value for accrued assets and liabilities at year end.
2. Total rate of return includes income and changes in the fair (market) prices for securities held by the funds during the period shown.
3. Common Pension Funds A, B and D are the principal vehicles for investment by the pension funds in domestic stocks, domestic bonds, and international securities, respectively. The returns cited are for the whole portfolios and include cash equivalents held.



# Unaudited Summary of Net Assets

June 30, 2003

(000's omitted)

	Consolidated Police & Firemen's Pension Fund	Judicial Retirement System of New Jersey	Police & Firemen's Retirement System
Domestic Equities		\$140,160	\$ 6,550,057
International Equities		52,980	2,006,895
Domestic Fixed Income	\$ 5,904	65,493	3,100,667
International Fixed Income		12,349	511,033
Forward Foreign Exchange Contracts		(86)	(3,237)
Police & Firemen's Mortgages			955,014
Pension Fund Cash Management Fund (1)	12,545	28,732	970,474
Other (2)	88	1,203	66,009
Total Net Assets	<u>\$18,537</u>	<u>\$300,831</u>	<u>\$ 14,156,912</u>

(1) The Pension Plans have separate Cash Management accounts that are not included here.

(2) "Other" represents adjustments to the net asset value for accrued assets and liabilities at year end.

<u>Prison Officers Pension Fund</u>	<u>Public Employees' Retirement System</u>	<u>State Police Retirement System</u>	<u>Teachers' Pension and Annuity Fund</u>	<u>Total</u>
	\$ 9,502,198	\$ 713,889	\$ 12,315,646	\$ 29,221,950
	2,883,436	257,784	4,100,258	9,301,353
\$ 11,267	6,031,186	328,980	7,029,559	16,573,056
	832,540	62,341	1,100,552	2,518,815
	(4,650)	(417)	(6,621)	(15,011)
				955,014
5,903	967,045	151,237	1,569,002	3,704,938
178	106,057	6,299	127,705	307,539
<u>\$ 17,348</u>	<u>\$ 20,317,812</u>	<u>\$ 1,520,113</u>	<u>\$ 26,236,101</u>	<u>\$ 62,567,654</u>

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**DIVISION OF INVESTMENT  
DEPARTMENT OF THE TREASURY  
STATE OF NEW JERSEY  
PENSION FUND**

**Financial Statements, Management's Discussion  
and Analysis and Supplemental Schedules**

**June 30, 2003**

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

**Statement of Net Assets**

The Statement of Net Assets presents the assets, liabilities and net assets of the Fund as of the end of the fiscal year. The Statement of Net Assets is a point in time financial statement. It presents end of the year data concerning assets, liabilities and net assets (assets less liabilities).

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Basic Financial Statements:	
Statement of Net Assets	6
Statement of Changes in Net Assets	7
Notes to Financial Statements	8
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1 Combining Schedule of Net Assets	13
2 Combining Schedule of Changes in Net Assets	14

**DIVISION OF INVESTMENT  
DEPARTMENT OF THE TREASURY  
STATE OF NEW JERSEY  
PENSION FUND**

**Management's Discussion and Analysis**

**June 30, 2003**

**Introduction**

This section of the financial statements of The Pension Fund (the Fund) presents our discussion and analysis of the Fund's financial performance during the fiscal year ended June 30, 2003. Since this discussion and analysis is designed to focus on current activities, it should be read in conjunction with the Fund's basic financial statements, which follow this section.

**Financial Statements**

Effective July 1, 2002, the Fund implemented the provisions of Governmental Accounting Standards Board Statement No. 34, "Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments" and Statement No. 37, "Basic Financial Statements and Management's Discussion and Analysis for State and Local Governments: Omnibus."

The Fund's basic financial statements include a statement of net assets and a statement of changes in net assets, which have been prepared in accordance with Governmental Accounting Standards Board (GASB) principles.

The statement of net assets provides information on the financial position of the Fund at year-end. The statement of changes in net assets presents the results of the investing activities during the year. The Notes to the Financial Statements offer additional discussion that is essential to the full understanding of the data presented in the financial statements. The notes give more detail about accounting policies, significant account balances and activities, material risks, obligations, contingencies and subsequent events, if any. The financial statements and related notes are prepared in accordance with GASB principles.

The Combining Schedule of Net Assets and Combining Schedule of Changes in Net Assets provides detail on an individual account basis (Common Fund A accounts, Common Fund B accounts, Common Fund D accounts and Other accounts).

**Statement of Net Assets**

The Statement of Net Assets presents the assets, liabilities and net assets of the Fund as of the end of the fiscal year. The Statement of Net Assets is a point in time financial statement. It presents end of the year data concerning assets, liabilities and net assets (assets minus liabilities).



The statement of net assets is comprised of five major categories as detailed below:

	<b>June 30, 2003</b>
	(Millions)
Cash and Cash Management Fund	\$ 3,705
Investments at fair value	58,555
Receivables'	538
Securities lending collateral	10,268
Total assets	73,066
Total liabilities	10,498
Net assets	\$ 62,568

Receivables consist primarily of pending investment transactions and dividends and interest receivable. Liabilities represent amounts owed for pending investment transactions and amounts due to borrowers under the securities lending program.

### Statement of Changes in Net Assets

Changes in net assets from year to year are presented in the statement of changes in net assets. The purpose of this statement is to present the net investment income earned by the Fund as well as the contributions of and distributions to participants. A summary follows:

	<b>June 30, 2003</b>
	(Millions)
Additions:	
Net investment income	\$ 1,916
Total additions	1,916
Deductions:	
Administrative expenses	48
Securities lending program expenses	31
Investment fees	3
Net pension fund withdrawals	2,610
Total deductions	2,692
Decrease in net assets	(776)
Net assets, beginning of year	63,344
Net assets, end of year	\$ 62,568

Net assets decreased by \$776 million, or 1.2%, during the current fiscal year. Net cash flow out of the pension funds amounted to \$2.7 billion, consisting primarily of pension fund withdrawals for benefits paid out to retirees and other beneficiaries and other withdrawals from the Fund.

Offsetting these payments was net investment income of \$1.92 billion, consisting primarily of dividends, interest and securities lending income. Changes in the market value of the underlying portfolio (net depreciation in fair value of investments) amounted to a net loss of \$24 million.

This small change in the market value of the underlying portfolio is consistent with market returns for the major asset classes comprising the overall portfolio. Overall, fixed income assets generated positive returns during the fiscal year, which was offset by negative returns on domestic and international equities. This is evidenced by the price returns (i.e., excluding dividends and interest) on the indices representing the major elements of the portfolio:

- The S&P 500 index excluding dividends, consisting of large capitalization U.S. equity securities, was down by 1.55% for the fiscal year;
- The price return on the Lehman Government/Credit Index, consisting of domestic investment-grade bonds, was a positive 7.2%;
- The MSCI EAFE index excluding dividends, consisting of international equities, was down by 8.66%.

## Independent Auditors' Report

### The Members

State Investment Council,  
Division of Investment,  
Department of the Treasury,  
State of New Jersey:

We have audited the accompanying statement of net assets of the Pension Fund (the Fund) of the Division of Investment, Department of the Treasury, State of New Jersey, as of June 30, 2003, and the related statement of changes in net assets for the year then ended. These financial statements are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in note 1, the financial statements present only the Fund and do not purport to, and do not, present fairly the financial position of the State of New Jersey as of June 30, 2003 and the changes in its financial position for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Pension Fund of the Division of Investment, Department of the Treasury, State of New Jersey, as of June 30, 2003, and the changes in its net assets for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in note 1, the Fund adopted Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, as amended by GASB Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*, as of July 1, 2002.

The management's discussion and analysis on pages 1 through 3 is not a required part of the basic financial statements but is supplemental information required by accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information included in Schedules 1 and 2 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

KPMG LLP

September 19, 2003

## Statement of Net Assets

June 30, 2003

<b>Assets:</b>	
Cash	\$ 253,100
Cash Management Fund	3,704,938,504
<b>Receivables:</b>	
Interest and dividends	305,090,201
Investments sold	226,611,632
Foreign taxes	5,748,531
Total receivables	<u>537,450,364</u>
Securities lending collateral	10,267,774,649
Investments, at fair value	58,555,175,343
Total assets	<u>73,065,591,960</u>
<b>Liabilities:</b>	
Investments purchased	230,163,597
Securities lending collateral and rebates payable	10,267,774,649
Total liabilities	<u>10,497,938,246</u>
Net assets	<u>\$ 62,567,653,714</u>
See accompanying notes to financial statements.	

## Statement of Changes in Net Assets

Year ended June 30, 2003

<b>Additions:</b>	
Net investment income:	
Interest and dividends	\$ 1,904,301,533
Net depreciation in fair value of investments	(23,771,772)
Securities lending income	35,681,145
Net investment income	<u>1,916,210,906</u>
<b>Deductions:</b>	
Administrative expenses:	
Division of Pensions and Benefits	41,458,665
Division of Investment	6,513,862
	<u>47,972,527</u>
Securities lending program rebates	29,639,396
Securities lending program agent fees	1,207,930
Investment fees	2,821,920
Net pension fund withdrawals	2,610,334,168
Total deductions	<u>2,691,975,941</u>
Decrease in net assets	(775,765,035)
Net assets as of beginning of year	<u>63,343,418,749</u>
Net assets as of end of year	<u>\$ 62,567,653,714</u>
See accompanying notes to financial statements.	



## Notes to Financial Statements

June 30, 2003

### (1) Organization

#### **Reporting Entity**

The Division of Investment, Department of the Treasury, State of New Jersey (the Division) manages and invests certain assets of various divisions, agencies and employees of the State of New Jersey in various groups of funds, such as the Pension Fund, the Deferred Compensation Fund and the Cash Management Fund. The accompanying financial statements represent the Pension Fund (the Fund) which is comprised of various accounts managed by the Division. The operations of this Fund are governed by the provisions of the State Investment Council Regulations for the purpose of investing in approved securities for the Fund.

The accounts included in the Fund are: Common Fund A, Common Fund B, Common Fund D, Police and Firemen's Mortgage Program accounts and other investments owned directly by the pension plans administered by the New Jersey Division of Pensions and Benefits. Common Fund A invests primarily in domestic equity securities. Common Fund B invests primarily in domestic fixed income securities. Common Fund D invests primarily in foreign securities. The Police and Firemen's Retirement System includes a mortgage loan program that provides participants with mortgages from the program at rates which are fixed by formula. The law establishing the program provides that the Fund may not sell the mortgages, and therefore no independent market exists for them. As of June 30, 2003, the mortgage loan program had a cost of \$951,480,611 and an appraised value of \$955,014,048, determined using market prices obtained from an independent broker.

The Fund is not legally separate from the State of New Jersey, and the assets managed by the Division are included in the financial statements of the State.

The accompanying financial statements present only the Fund and do not purport to, and do not, present fairly the financial position of the State of New Jersey as of June 30, 2003, and changes in its financial position for the year then ended in conformity with accounting principles generally accepted in the United States of America.

#### **Changes in Financial Reporting**

Effective, July 1, 2002, the Fund implemented the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments* and Statement No. 37, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments: Omnibus*.

The financial statements for the previous year ended June 30, 2002 were presented in a variety of formats, with Common Fund A, Common Fund B and Common Fund D presented separately. For the year ended June 30, 2003 assets of similar types, such as the assets of the pension plans, were combined into reporting groups, such as the Fund.

The Fund is considered to be an investment trust fund as defined in GASB 34.

## **(2) Summary of Significant Accounting Policies**

### ***Measurement Focus and Basis of Accounting***

The financial statements are reported using the economic resources management focus and the accrual basis of accounting. Under this method, revenues (additions) are recorded when earned and expenses (deductions) are recorded at the time liabilities are incurred, regardless of when the related cash flow takes place.

### ***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.

### ***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.

Net depreciation in fair value of investments includes net realized losses and unrealized gains on investments for the year ended June 30, 2003. The net realized loss from investment transactions amounted to \$1,147,282,358 and the net increase in unrealized gains on investments amounts to \$1,123,510,586 for the year ended June 30, 2003.

### ***Unit Transactions***

The net asset value of the Fund is determined as of the close of the last day of business of each month (Common Fund A and B) or quarter (Common D). Purchases and redemptions of participants' units are transacted each month or quarter 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 quarterly for Common D. The income earned on Common Fund D units is reinvested.

### ***Net Pension Fund Withdrawals***

The net pension fund withdrawals represent a combination of participant distributions and other pension plan withdrawals offset by participant contributions. The withdrawals from pension plan assets are made based upon the cash disbursement needs of the individual pension plans.

## **Administrative Expenses**

The administrative expenses of the Division of Investment and the Division of Pensions and Benefits are paid by the Department of the Treasury of the State of New Jersey. These expenses are reimbursed by charges to the individual pension plans administered by the Division of Pensions and Benefits. The withdrawal of the funds from pension plan assets to provide this reimbursement to the Department of the Treasury is reflected as administrative expenses in the accompanying financial statements.

## **Securities Lending**

Common Fund A and Common Fund B participate in a securities lending program at its custodian bank, whereby securities are loaned to brokers and, in return, the Fund has rights to the collateral received. All of the Fund's securities in Common Fund A and B 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% of the value of the loaned securities at the time the loan is made. In the event that the market value of the collateral is less than 101% of the market value of all the outstanding loaned securities, additional collateral shall be transferred 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. As of June 30, 2003, the fund has no aggregate credit risk exposure to brokers because the collateral amount held by the Fund exceeds the market value of the securities on loan.

The contract with the Fund's custodian bank requires it to indemnify the Fund if the brokers fail to return the securities or fail to pay the Fund for income distributions by the securities' issuers while the securities are on loan. The securities loans can be terminated by notification by either the broker or the Fund. As of June 30, 2003, the Fund had outstanding loaned investment securities having market values of \$10,042,312,876; against which it had received collateral with a current value of \$10,267,774,649.

## **Derivatives**

The Fund's international managers invest in forward foreign currency contracts, a derivative security. 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 interest 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 Fund's foreign stock and fixed income portfolios.

The fair value of foreign forward currency contracts outstanding as of June 30, 2003 is as follows:

Forward currency receivable	\$ 959,947,170
Forward currency payable	974,958,415
Net unrealized loss	15,011,245

The net unrealized loss of \$15,011,245 is included in investments in the accompanying statement of net assets.



## Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of income and expense during the reporting period. Actual results could differ from those estimates.

### (3) Summary of Custodial Risk

GASB Statement No. 3 requires disclosure of the level of custodial risk assumed by the Fund as of June 30, 2003. Such disclosures categorize the investments based upon who holds them and how they are held. Category 1 includes investments that are insured or registered or for which securities are held by the Fund's agent in the Fund's name. Investment in pooled funds are not categorized because they are not evidenced by securities that exist in physical or book entry form.

The Fund's investments are categorized as follows:

	Total	Category 1	Non-categorized
Securities lending cash in transit	\$ 454,937	454,937	—
Domestic equities	29,221,950,916	27,706,915,771	1,515,035,145
International equities	9,301,352,272	9,301,352,272	—
Domestic fixed income	22,749,223,679	14,221,945,948	8,527,277,731
International fixed income	2,518,813,715	2,518,813,715	—
Domestic floating rate securities	3,702,411,670	3,702,411,670	—
Repurchase agreements	388,740,000	388,740,000	—
Police and Firemen's mortgages	955,014,048	—	955,014,048
Forward foreign exchange contracts	(15,011,245)	(15,011,245)	—
	<u>\$ 68,822,949,992</u>	<u>57,825,623,068</u>	<u>10,997,326,924</u>

Category 1 in the above table includes securities lending collateral of \$10,267,774,649. Securities loaned under such agreements of \$10,042,312,876 as of June 30, 2003 are included in non-categorized in the above table.



## Combining Schedule of Net Assets

### June 30, 2003

	Common Fund A Accounts	Common Fund B Accounts	Common Fund D Accounts	Other Accounts	Eliminations	Total
<b>Assets:</b>						
Cash	\$ 1,281	689	251,130	—	—	253,100
Cash Management Fund	423,647,742	837,553,821	205,077,085	2,238,659,856	—	3,704,938,504
<b>Receivables:</b>						
Interest and dividends	33,335,612	221,982,188	33,456,474	16,315,927	—	305,090,201
Investments sold	18,732,122	136,093,750	71,785,760	—	—	226,611,632
Foreign taxes	—	—	5,748,531	—	—	5,748,531
Undistributed income due participants	—	—	—	332,290,171	(332,290,171)	—
<b>Total receivables</b>	<b>52,067,734</b>	<b>358,075,938</b>	<b>110,990,765</b>	<b>348,606,098</b>	<b>(332,290,171)</b>	<b>537,450,364</b>
Securities lending collateral	1,590,107,129	8,677,667,520	—	—	—	10,267,774,649
Investments, at fair value	29,346,333,076	16,179,551,244	10,710,364,469	2,318,926,554	—	58,555,175,343
<b>Total assets</b>	<b>31,412,156,962</b>	<b>26,052,849,212</b>	<b>11,026,683,449</b>	<b>4,906,192,508</b>	<b>(332,290,171)</b>	<b>73,065,591,960</b>
<b>Liabilities:</b>						
Undistributed income due participants for quarter ended June 30, 2003	135,510,776	196,779,395	—	—	332,290,171	—
Investments purchased	16,384,854	125,977,600	87,801,143	—	—	230,163,597
Securities lending collateral and rebates payable	1,590,107,129	8,677,667,520	—	—	—	10,267,774,649
<b>Total liabilities</b>	<b>1,742,002,759</b>	<b>9,000,424,515</b>	<b>87,801,143</b>	<b>—</b>	<b>332,290,171</b>	<b>10,497,938,246</b>
<b>Net assets</b>	<b>\$ 29,670,154,203</b>	<b>17,052,424,697</b>	<b>10,938,882,306</b>	<b>4,906,192,508</b>	<b>—</b>	<b>62,567,653,714</b>

## Combining Schedule of Changes in Net Assets

### June 30, 2003

	Common Fund A Accounts	Common Fund B Accounts	Common Fund D Accounts	Other Accounts	Total
Additions:					
Net investment income:					
Interest and dividends	\$ 491,618,393	950,501,961	254,878,698	207,302,481	1,904,301,533
Net (depreciation) appreciation in fair value of investments	(446,639,382)	1,240,530,729	(808,749,314)	(8,913,805)	(23,771,772)
Securities lending income	8,074,466	27,606,679	—	—	35,681,145
Net investment income	<u>53,053,477</u>	<u>2,218,639,369</u>	<u>(553,870,616)</u>	<u>198,388,676</u>	<u>1,916,210,906</u>
(Additions) deductions:					
Administrative expenses:					
Division of Pensions and Benefits	—	—	—	41,458,665	41,458,665
Division of Investment	—	—	—	6,513,862	6,513,862
	<u>—</u>	<u>—</u>	<u>—</u>	<u>47,972,527</u>	<u>47,972,527</u>
Securities lending program rebates	5,959,860	23,679,536	—	—	29,639,396
Securities lending program agent fees	422,921	785,009	—	—	1,207,920
Investment fees	—	—	—	2,821,920	2,821,920
Net pension fund (additions) withdrawals	(706,765,885)	3,373,466,609	(400,006,825)	343,640,269	2,610,334,168
Total (additions) deductions	<u>(700,383,104)</u>	<u>3,397,931,154</u>	<u>(400,006,825)</u>	<u>394,434,716</u>	<u>2,691,975,941</u>
Increase (decrease) in net assets	753,436,581	(1,179,291,785)	(153,863,791)	(196,046,040)	(775,765,035)
Net assets as of beginning of year	<u>28,916,717,622</u>	<u>18,231,716,482</u>	<u>11,092,746,097</u>	<u>5,102,238,548</u>	<u>63,343,418,749</u>
Net assets as of end of year	<u>\$ 29,670,154,203</u>	<u>17,052,424,697</u>	<u>10,938,882,306</u>	<u>4,906,192,508</u>	<u>62,567,653,714</u>



