

NOTE 8 – DEPOSITS AND INVESTMENTS

This note provides information for all deposits and investments except those of the Common Cash pool, which are described in Note 5.

A. Deposits - Primary Government

Custodial Credit Risk

In addition to equity in the Common Cash pool, some State funds maintain deposits with financial institutions. At present, only the Michigan Unemployment Compensation Funds (MUCF), the State Treasurer's Escrow and Paying Agent Fund, and the Michigan Educational Savings Plan maintain these deposits and are exposed to custodial credit risk.

The Michigan Employment Security Commission (MESC) administers, under the auspices of the federal government, the deposits of the MUCF. Tax collections are deposited in a clearing account as required by the Michigan Employment Security Act. Refunds are paid from that account; after the clearance of vouchers for refunds, all other money remaining in the fund, less amounts needed for refunds and judgments, must be deposited with the secretary of the treasury of the United States of America to the credit of the State in the Unemployment Trust Fund, established and maintained pursuant to Section 904 of the Social Security Act, 42 USC 1104. These deposits are maintained in the Federal Reserve Bank. At year-end, the carrying amount of these deposits, excluding those classified as investments, was negative \$9.4

million, which was caused by a net book cash overdraft. The bank balance of the deposits was \$15.9 million, of which \$.1 million was covered by federal depository insurance and \$15.8 was book-entry securities held by pledging custodial banks at the Federal Reserve Bank in the State's name.

The deposits of the State Treasurer's Escrow and Paying Agent Fund were reflected in bank accounts at \$1.6 million; these deposits were uninsured and uncollateralized, and were therefore exposed to custodial credit risk. This fund was administratively created and is used to account for investments held in escrow by the State Treasurer as fiscal agent for hospitals that have defeased Michigan State Hospital Finance Authority (MSHFA) bonds. MCL 331.73g(1) allows that the deposits shall be held in trust by the State Treasurer or by a financial institution qualified to serve as trustee pursuant to a trust agreement entered into between the authority issuing the refunding bonds and the State Treasurer or the financial institution providing for the investment and disposition of the funds.

The deposits of the Michigan Educational Savings Program were reflected in bank accounts at \$.6 million; \$.1 million was insured and \$.5 million was exposed to custodial credit risk. The program has no policy for controlling this risk.

B. Investments - Primary Government

The following table shows the carrying amounts and fair values of investments of the primary government by investment type and in total (in millions) at September 30, 2005:

Primary Government Total Investments (In millions)				
Investment Types	Pension Funds	Deferred Compensation/ Defined Benefit Funds	Other Funds	Total
Commercial paper	\$ 2,774.2	\$ -	\$ -	\$ 2,774.2
Government securities	4,031.8	-	1,466.9	5,498.6
Money market accounts	-	-	210.6	210.6
Money market funds	-	182.7	42.6	225.3
Corporate bonds and notes	4,105.9	-	132.8	4,238.7
Mutual funds	105.7	1,885.2	875.7	2,866.6
Pooled investment funds	-	1,916.9	-	1,916.9
Equities	24,374.5	-	150.7	24,525.2
Guaranteed investment contracts	-	-	6.0	6.0
Funding agreements	-	-	150.5	150.5
International	6,160.5	-	-	6,160.5
Real estate	3,842.5	-	-	3,842.5
Alternative	5,807.8	-	-	5,807.8
Accrued income	125.8	-	-	125.8
Cash collateral	(174.4)	-	-	(174.4)
Unsettled investments	(54.6)	-	-	(54.6)
Total	\$ 51,099.8	\$ 3,984.8	\$ 3,035.8	\$ 58,120.3
<u>As reported on the Statement</u>				
<u>Of Net Assets</u>				
Current investments	\$ 936.8			
Noncurrent investments	972.8			
Total Investments	\$ 1,909.6			

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As reported on the Statements of Net Assets and Statement of Fiduciary Net Assets

	Current Investments	Noncurrent Investments	Total
Governmental Activities	\$ 210.6	\$ 551.9	\$ 762.5
Business-type activities	726.2	420.9	1,147.1
Fiduciary funds	1,786.1	54,424.6	56,210.7
Total Investments	<u>\$ 2,723.0</u>	<u>\$ 55,397.4</u>	<u>\$ 58,120.3</u>

Authority

Investment authority for the State's pension (and other employee benefit) trust funds is found in P.A. 314 of 1965, as amended. This act allows the State Treasurer, as investment fiduciary, to make diverse investments in stocks, corporate and government bonds and notes, mortgages, real estate, venture capital, and other investments. The act has prudence standards and requires that the assets of a retirement system shall be invested solely in the interest of the participants and beneficiaries, and be made for the exclusive purpose of providing benefits to the participants and the participants' beneficiaries, and of defraying reasonable expenses of investing the assets of the State system.

The investment authority for other State funds is found in their enabling statutes and/or their bond resolutions where applicable. Except as noted below, the investments of the non-pension (and other employee benefit) trust funds are comprised mostly of United States government securities.

The State Building Authority makes diverse investments as allowed by State statute and/or bond resolutions.

Investments of MUCF represent their interest in a U.S. Treasury trust fund managed by the Secretary of the Treasury pursuant to Title IX of the Social Security Act, which includes deposits from the unemployment compensation funds of various states. MUCF is credited quarterly with trust fund investment earnings, as computed on a daily basis.

The deferred compensation plans are invested in mutual funds, U.S. Treasury strips, money market funds, and pooled investment funds. During fiscal year 2004-2005, the deferred compensation plans' investment activities were managed by a private investment firm, which invests as directed by members of the plan.

Derivatives

The State Treasurer is also authorized to invest a limited amount of pension (and other employee benefit) trust funds in futures contracts. Such investments were made in Standard & Poor's 500 and Standard & Poor's Midcap Index futures contracts during the year. At September 30, 2005, there was \$174.8 million invested in futures contracts. Derivatives are used for a small amount of the pension (and other employee benefit) trust fund portfolios to provide additional diversification. However, derivatives are not used for speculation and they are not used to leverage the investment portfolios. Approximately 10% of the total pension (and other employee benefit) trust funds portfolio has been invested from time to time in futures contracts and swap agreements. The swap agreements provide that the retirement systems will pay quarterly, over the term of the swap agreements, interest indexed to the three month London Interbank Offered Rate (Libor), adjusted for an interest rate spread, on the notional amount stated in the agreements. United States domestic Libor-based floating rate notes were purchased in the open market to correspond with the notional amount of the swap agreements. The State Treasurer maintains custody and control of these notes. Swap

agreements represent the largest category of derivatives used and total approximately 10.0% of the total portfolio.

Investment Pools

In July 2004, four state retirement systems' (State Employees', State Police, Public School Employees', and Judges') investments were contributed to an investment pool structure. A pro rata share of the entire pool represents each system's ownership of a portion of the investments in the State's pool.

Repurchase Agreements

As a matter of administrative policy, the State Treasurer makes only limited use of investments in repurchase agreements. No such investments were outstanding at year-end.

Risk

GASB Statement No. 40 requires certain disclosures regarding policies and practices with respect to the risks associated with investments. The custodial credit risk, the credit risk, the interest rate risk, the foreign currency risk and concentration of credit risk are discussed in the following paragraphs.

Custodial Credit Risk

Custodial credit risk for investments is the risk that, in the event of a failure of the counterparty to a transaction, the State will not be able to recover the value of the investment or collateral securities that are in the possession of an outside party.

Investment securities are exposed to custodial credit risk if the securities are uninsured, are not registered in the name of the government and are held by either the counterparty, or the counterparty's trust department or agent, but not in the government's name.

The State Treasurer does not have a policy for limiting custodial credit risk. As of September 30, 2005, government securities with a market value of \$50.0 million were exposed to custodial credit risk. These securities were held by the counterparty, not in the name of the retirement systems.

Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. Short-term investment for the pensions funds are in prime commercial paper and follow the same policy described in Note 5 for this type of investment. The ratings at September 30 are included in the rated debt investment table.

All long-term fixed income investments, unless unrated, must be investment-grade at the time of purchase. Investment grade, as defined in P.A. 314 of 1965, as amended, includes: investments in the top four major grades, rated by two national rating services. The State Treasurer's policy is to use Standard & Poor's (AAA, AA, A, BBB); and Moody's (Aaa, Aa, A, Baa). The primary government's rated debt investments as of September 30, 2005, are presented below. Note that securities backed by the full faith and credit of the United States Government are excluded.

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Investment Type	Debt Investments (In millions)			
	Fair Value	Rating S & P	Fair Value	Rating Moody's
Pension (and Other Employee Benefit) Trust Funds:				
Retirement Systems:				
Commercial paper	\$ 2,191.5	A-1	\$ 2,400.9	P-1
	99.4	A-2	99.4	P-2
	483.2	Unrated	273.9	Unrated
Government securities				
U.S. agencies – sponsored	2,499.1	AAA	2,499.1	Aaa
Corporate bonds & notes				
	698.6	AAA	698.6	Aaa
	951.6	AA	1,131.4	Aa
	1,681.8	A	1,475.2	A
	393.2	BBB	495.4	Baa
	316.7	BB	140.0	Ba
	64.0	Unrated	165.2	Unrated
International*				
	859.7	AAA	859.7	Aaa
	984.8	AA	1,684.7	Aa
	2,059.5	A	1,329.6	A
	100.0	BB	100.0	Ba
			30.0	Unrated
Equity*				
	50.0	AA	100.0	Aa
	50.0	A	-	-
Mutual funds	68.5	Unrated	68.5	Unrated
Total	<u>13,551.7</u>		<u>13,551.7</u>	
Deferred Compensation/Defined Contribution:				
Common trust funds	\$ 1,053.1	AAA	\$ 1,060.6	Aaa
	269.9	AA	269.9	Aa
	20.0	Unrated	12.4	Unrated
Mutual funds	53.1	AA	53.0	Unavailable
Money market funds	182.7	AI	182.7	Unavailable
Total	<u>1,578.7</u>		<u>1,578.7</u>	
Other Primary Government Funds:				
Government securities				
U.S. agencies – sponsored	\$ 259.6	AAA	\$ 259.6	Aaa
	6.8	Unrated	6.8	Unrated
Corporate bonds & notes				
	69.4	AAA	75.0	Aaa
	15.2	AA	-	-
	45.2	A	57.8	A
	3.0	BBB	-	-
Guaranteed investment contract	6.0	Unrated	6.0	Unrated
Mutual funds				
	212.8	AAA	212.8	Unavailable
	69.4	AA	69.4	Unavailable
	1.9	Unrated	1.9	Unrated
Treasury trust fund pool	631.0	Unrated	631.0	Unrated
Total	<u>1,320.2</u>		<u>1,320.2</u>	
Total Primary Government	<u>\$ 16,450.6</u>		<u>\$ 16,450.6</u>	

*International and Equity Investment types consist of domestic floating rate notes that are used as part of a Swap strategy.

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Interest Rate Risk

Interest rate risk is the risk that changes in interest rates of debt investments will adversely affect the fair value of those investments.

The State Treasurer's policy states that cash equivalents are invested in short term fixed income securities with an average weighted maturity of less than one year to provide liquidity and safety of principal from capital market and default risk. At September 30, 2005, the fair value of prime commercial paper was \$2.8 billion; the weighted average maturity was 38 days.

The State Treasurer does not have a policy regarding interest rate risk for long-term debt investments. However, the pension

trust funds are invested with a long-term strategy with no investments with a maturity of less than one year at the time of purchase. The goal is to balance higher returns while accepting minimum risk for the return. Analyzing the yield curve on individual securities as compared to U.S. Treasuries determines, in part, what is an acceptable risk for the return. Therefore, market conditions such as lower interest rates result in shorter duration; higher interest rates result in longer duration.

As of September 30, 2005, the pension trust funds had the following long-term debt securities:

Pension (and Other Employee Benefit) Trust Funds		
Debt Securities		
(In millions)		
	Fair Value	Duration In Years
Retirement Systems:		
Governmental		
U.S. Treasury	\$ 398.3	4.3
U.S. Agency - Backed	1,134.3	5.3
U.S. Agency - Sponsored	2,499.1	2.5
Total Government	4,031.8	
Corporate	4,105.9	4.1
International*		
U.S. Agency - Sponsored	50.0	.1
Corporate	3,954.1	.2
Total International	4,004.1	
Equities*	100.0	.2
Mutual fund - fixed income	68.5	4.4
Total	\$12,310.1	
Deferred Compensation/Defined Benefit:		
Common trust funds		
Traditional GIC/BICs	\$ 199.9	1.4
Buy and hold synthetics	43.3	1.9
Global wrap synthetic contracts	1,029.8	3.1
SSgA daily bond market index fund	70.1	4.4
Money market funds	182.7	.1
Mutual fund	53.0	5.1
Total	1,578.7	
Total Pension (and Other Employee Benefit) Trust Funds	\$13,888.9	

*International and Equities contain Domestic Government and Corporate Securities as a part of their derivative strategies. The interest rates reset on a quarterly basis for these securities.

For the other primary government funds, fixed income is invested in a laddered, time-segmented structure allowing for intermittent cash flows as needed.

As of September 30, 2005, the primary government, excluding pension trust funds, had the following long-term debt securities:

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Investment Type	Other Funds Debt Securities (In millions)				
	Investment Maturities (In Years)				
	Fair Value	Less Than 1	1 To 5	6 To 10	More Than 10
U.S. Treasury SLGS	\$ 44.8	\$ 11.1	\$ 33.8	\$ -	\$ -
U.S. Treasury bonds	514.3	93.4	261.1	126.8	33.0
U.S. Bonds - backed	10.4	-	.4	1.6	8.4
U.S. Agency bonds - sponsored	266.4	-	28.7	173.9	63.8
Corporate bonds	132.8	-	25.15	57.9	49.8
Guaranteed investment contracts	6.0	-	6.0	-	-
Mutual funds	284.0	1.9	-	212.8	69.4
Total	\$ 1,258.8	\$ 106.3	\$ 355.0	\$ 573.1	\$ 224.4

Foreign Currency Risk

Foreign currency risk is the risk that changes in exchange rates will adversely affect the fair value of investments or deposits.

The pension trust funds invest in various foreign securities. These investments are limited to 20% of the total assets of the system, and are additionally limited to 5% of the outstanding foreign securities of any single issuer. No investment is allowed in a country that has been identified by the United States State

Department as engaging in or sponsoring terrorism. These limits are set forth in P.A. 314 of 1965, as amended. The types of foreign securities include equities, fixed income, mutual funds, and limited partnerships. At September 30, 2005, foreign investments were less than 5% of total assets of the systems; total foreign investments were \$2.3 billion. As of September 30, 2005, the pension (and other employee benefits) trust funds held the following investments subject to foreign currency risk:

Pension (and Other Employee Benefit) Trust Funds
Foreign Currency Risk
(In millions)

Currency	Country	Market Value (In U.S. Dollars)			
		Alternative Investments	Equities	Equities - International	
Equities	Derivatives*				
Retirement Systems:					
Americas					
Real	Brazil	\$ -	\$.4	\$ -	\$ -
Peso	Mexico	-	260.1	-	-
Europe					
Euro	European Union	338.9	1.4	67.9	168.7
Franc	Switzerland	-	32.2	-	25.8
Krona	Sweden	-	-	.4	15.0
Krone	Denmark	-	-	1.6	9.3
Krone	Norway	-	-	1.8	9.0
Sterling	United Kingdom	29.8	177.1	41.6	94.1
Asia/Pacific					
Dollar	Australia	-	-	.4	42.1
Dollar	Hong Kong	-	-	6.1	11.3
Yen	Japan	8.6	-	4.5	128.2
Dollar	New Zealand	-	-	-	1.9
Won	Singapore	-	-	-	6.3
Won	South Korea	-	-	-	24.7
Mutual Funds					
Various	Various	-	20.3	757.7	-
Total		\$ 377.3	\$ 491.5	\$ 882.0	\$ 536.2
Deferred Compensation/Defined Contribution:					
Mutual Funds					
Various	Various	\$ -	\$ 302.0	\$ -	\$ -
Total		\$ 377.3	\$ 793.5	\$ 882.0	\$ 536.2

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*International derivatives' market value exposure to foreign currency risk is the net amount of unrealized gains and unrealized losses. Maturity dates on these investments range from October 2005 through September 2008, with an average maturity of 1.5 years. For more information, see the derivatives section of this note.

Concentration of Credit Risk

Concentration of credit risk is the risk of loss attributable to the magnitude of a government's investments with a single issuer.

Other than obligations issued that are assumed or guaranteed by the United States, its agencies, or United States government-sponsored enterprises, the pension systems are prohibited by P.A. 314 of 1965, as amended, from investing in more than 5% of the outstanding obligations of any one issuer or investing more than 5% of a system's assets in the obligations of any one issuer.

At September 30, 2005, there were no investments in any single issuer more than 5% of the system's assets, nor were there any investments totaling more than 5% of the obligations of any one issuer, other than U.S. Government Securities as described above.

Pension trust fund investments represent 94.8% of the total investments of the primary government. Other large holders of investments were the State Lottery Fund and MUCF.

The State Lottery Fund investments, \$514.3 million, are all in the form of zero coupon U.S. Treasury bonds. These investments are held to provide funding for deferred prize awards.

Securities Lending Transactions

Under the authority of P.A. 314 of 1965, the State lends securities to broker-dealers and other entities for collateral that will be returned for the same securities in the future. The custodian is not liable for any losses unless there is negligence or willful misconduct on its part. State statutes allow the State to participate in securities lending transactions, via a Securities Lending Authorization Agreement, authorizing the agent bank to lend its securities to broker-dealers and banks, pursuant to a form of loan agreement. During the fiscal year, the agent bank, at the direction of the State Treasurer, lent securities and received: cash (United States and foreign currency), securities issued or guaranteed by the United States government, sovereign debt rated A or better, convertible bonds, Canadian provincial debt, and irrevocable bank letters of credit as collateral. The agent bank did not have the ability to pledge or sell collateral securities delivered absent a borrower default. Borrowers were required to deliver collateral for each loan equal to: 1) in the case of loaned securities denominated in United States dollars or whose primary trading market was located in the United States or sovereign debt issued by foreign governments, 102% of the market value of the loaned securities; or 2) in the case of loaned securities not denominated in United States dollars or whose primary trading market was not located in the United States, 105% of the market value of the loaned securities.

The State Treasurer did not impose any restrictions during the fiscal year on the amount of the loans that the agent bank made

on its behalf. The agent bank indemnified the State by agreeing to purchase replacement securities, or return cash collateral in the event the borrower failed to return the loaned securities or pay distributions thereon. There were no such failures by any borrowers to return loaned securities or pay distributions thereon during the fiscal year. Moreover, there were no losses during the fiscal year resulting from a default of the borrowers or the agent bank.

During the fiscal year, the State Treasurer and the borrowers maintained the right to terminate all securities lending transactions on demand. The cash collateral received on each loan was invested in a collective investment pool along with the cash collateral of other qualified and non-qualified tax-exempt plan lenders. As of September 30, 2005, the investment pool had an average duration of 45 days and an average expected maturity of 404 days. Because the loans were terminable at will, their duration did not generally match the duration of the investments made with cash collateral. At September 30, 2005, the retirement systems had no credit risk exposure to borrowers. The collateral held and the market value of securities on loan for the State as of September 30, 2005, were \$3.4 billion and \$3.3 billion, respectively.

C. Deposits and Investments - Discretely Presented Component Units

Deposits

At year-end, the carrying amount of discretely presented component units deposits, excluding those classified as investments, was \$158.4 million. The deposits were reflected in the accounts of the banks at \$164.9 million. Of the bank balance, \$143.9 million was uninsured and uncollateralized and therefore exposed to custodial credit risk.

Investments

The investment authority for most discretely presented component units is typically found in their enabling statutes and/or their bond resolutions where applicable. Those component units that are financing authorities generally may invest in government or government backed securities and deposits. The Michigan Education Trust's investments are subject to an investment agreement with the State Treasurer that allows the Treasurer, acting as agent, to make diverse investments including stocks, bonds, notes, and other investments. Investment policies for the State universities are typically set forth by their governing boards and include a broad range of investment types.

Restricted Assets

Restricted investments on the government-wide Statement of Net Assets, totaling \$346.8 million, represent amounts that are pledged toward the payment of outstanding bonds and notes.

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The following table summarizes the investment maturities reported by the discretely presented component units (in millions):

	Investment Maturities (In Years)					
	Fair Market Value	Less Than 1	1 To 5	6 To 10	More Than 10	N/A
Deposits:						
Time deposits	\$ 49.4	\$ 41.7	\$ 7.6	\$ -	\$ -	\$ -
Government money market accounts	71.0	71.0	-	-	-	-
Investments:						
Commercial paper	128.0	128.0	-	-	-	-
Short-term notes	98.8	95.2	1.5	1.9	.2	-
Repurchase agreements	326.5	15.6	300.8	-	10.2	-
Government securities	1,949.3	1,037.9	499.0	210.7	200.6	1.2
Insured mortgage backed securities	217.4	2.2	6.2	.3	208.7	-
Government backed securities	190.3	18.6	4.2	2.1	165.5	-
Investment agreements	31.0	10.3	-	-	20.7	-
Corporate bonds and notes	296.7	16.0	117.6	143.6	19.4	.1
Preferred stock	1.1	-	-	-	.9	.2
Equities	92.7	30.6	2.5	-	14.4	45.1
Real estate	3.6	.7	-	-	2.8	.1
Venture capital & leveraged buyouts	18.0	-	-	11.7	6.3	-
Government money market funds	11.5	6.8	4.7	-	-	-
Mutual Bond Funds	339.1	171.2	133.6	34.1	.2	-
Mutual Equity Funds	693.7	234.2	-	-	228.0	231.5
Guaranteed investment contracts	943.0	-	426.7	6.9	509.4	-
Pooled investment funds	22.1	22.1	-	-	-	-
Other investments	15.6	.8	-	-	13.6	1.2
Total Investments	\$ 5,498.8	\$ 1,902.8	\$ 1,504.4	\$ 411.3	\$ 1,400.9	\$ 279.4

Less Investments Reported as
"Cash" on Statement of Net Assets
Net Assets

477.5
\$ 5,021.3

As Reported on Statement of Net Assets

Current investments	\$ 1,318.4
Noncurrent restricted investments	346.8
Noncurrent investments	3,356.2
Total Investments	\$ 5,021.3