Annual Report

State of Vermont

Office of the State Treasurer

Jeb Spaulding
State Treasurer

January 15, 2004

Vertmont State Capitol
Montpelier

The picture on the cover is reproduced from an original painting by Bruce Mitchell. It is one of forty-four paintings commissioned by First Vermont Bank depicting noteworthy firsts in the 200-year history of Vermont. To celebrate the 200th birthday of the country (1976) and the Green Mountain State (1977), the original painting of the Capitol was presented to the people of Vermont from the people of First Vermont Bank. The painting may be seen in the Governor's Office reception area in the Pavilion Building.

2003 Annual Report, State of Vermont
Office of the State Treasurer

Protecting Vermont's financial future, we strive to:

- ♦ **Be the best office of the treasury in the USA.**
- ♦ **Offer the best customer service possible.**
- ♦ **Do our part to make this office a great place to work.**
- ♦ **Give Vermont taxpayers an excellent value.**

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Office of the State Treasurer
State of Vermont

TO: Members of the General Assembly
Honorable James H. Douglas, Governor
Citizens of Vermont

It is with great satisfaction that I submit to you the 2003 Annual Report for the Office of the State Treasurer. This report summarizes the services we provide, the financial results of our capital financing and investment efforts, and the accomplishments of this office over the past year, as well as other matters within the purview of our office.

The Office of the State Treasurer is committed to maintaining Vermont's hard-earned reputation as a fiscally sound and disciplined state. We are pleased to report continued progress in reducing our debt burden, as well as improved investment performance. I am equally proud to report to you on some of the recent initiatives we have undertaken to improve the efficiency of our operations, protect consumer interests, and promote corporate responsibility. Much of our success in the past year is the result of mutual cooperation with the Legislature, the Administration, and the Office of the Auditor of Accounts. We look forward to continuing this kind of partnership in the future. I would like to begin by highlighting some of our accomplishments from the past year.

Bank Reconciliation

Reconciliation provides a key internal control to detect posting errors or fraudulent activity. The Office of the State Treasurer has made concerted efforts to bring its bank reconciliations current, improving cash control and check fraud procedures. The engagement by former Treasurer Douglas of a consulting CPA firm, Mudgett Jennett & Krogh-Wisner, P.C., to review our procedures and recommend improvements was a significant initial step. A series of joint reviews of the reconciliation process with the Department of Finance and Management assisted the Office of the State Treasurer in resolving procedural and systemic issues. A more formal tracking system to review reconciliation progress is now in place. Tracking of reconciliations has indicated that by March 2003, many were reconciled within 30 days of the monthly accounting close. Reconciliation timeliness has continued to improve; as of November 2003, all Treasury bank accounts became current. We plan to maintain a target of completion of reconciliations within 30 days from the close of the accounting period.

Unitization of Pension Investments

The Office of the Treasurer, working with the three retirement boards, has developed a proposal to save approximately one million dollars per year in investment management fees for Vermont's three State-level pension funds, and to strengthen the investment oversight and management process of the three funds.

This results from a directive by the 2003 General Assembly to develop a proposal to unitize the assets of State pension funds. Unitization is a form of investment accounting that allows one pension fund's assets to be pooled with the assets from other pension funds for investment purposes, while maintaining a separate identity for actuarial, accounting, and asset allocation purposes. Each pension fund in a unitized system essentially owns shares in a pool. Investment growth and income are allocated to the individual funds based on the number of shares owned. Since investment management fees are based on the size of the portfolio under management, the consolidation of managers for investments in common asset classes will considerably reduce management fees. Under the proposal, the three existing retirement boards would continue to oversee areas such as actuarial valuation, benefits, and general administration, but a new joint investment committee made up of board members and investment experts would be responsible for investment of the assets for each of the three Vermont Retirement Systems. In December 2003, all three retirement boards voted to support the proposal in concept. My office has now submitted the proposal to the General Assembly for consideration. A copy of the proposal is included as an Appendix of this annual report.

Capital Financing and Debt

While the national trend has been toward increased indebtedness, the State of Vermont continues to impress the financial community by reducing its total level of outstanding long-term debt. The State's net tax-supported debt has fallen from $503.8 million in fiscal year 2000 to $448.2 million for fiscal year 2003. You will note, in the debt management section of this report, that we continue to improve in many of the major debt indices used by the rating agencies. Vermont continues to enjoy the highest composite bond rating of any New England state. A recent Fitch Ratings publication stated, "Vermont's conservative approach to debt and financial operations provides a strong foundation for high credit quality." [FITCH RATINGS — PUBLIC FINANCE, December 9, 2002] Several positive factors have been taken into consideration by the rating agencies, including the following:

- Healthy stabilization reserve levels that position the State to accommodate revenue shortfalls.
- Swift and prudent actions to balance the FY'02, FY'03, and FY'04 budgets, including the downward revision of revenue projections and reductions of appropriations as the economy weakened.
- An uncomplicated debt management system with a nearly exclusive use of general obligation debt.
- A favorable and manageable debt burden that is declining due to rapid amortization schedules and reductions in the State's debt issuance.

Notwithstanding these accomplishments, tax-supported debt remains relatively high in Vermont. Only 15 states have more tax-supported debt per capita. Only 16 states have more tax-supported debt as a percent of personal income. The State must continue to stabilize its debt position in order to preserve and, hopefully, further enhance its current ratings.

On September 30, 2003, the Capital Debt Affordability Advisory Committee (CDAAC) voted unanimously to recommend raising the state's annual capital bonding level to $41 million, a 5% increase, for the FY'05. From 1999 until this year, the Committee had recommended a level of $39 million in new bonding each year. At its September 2002 meeting, the Committee agreed to consider building in an inflation factor in the future. The Committee held a public hearing in August 2003 and considered possible bonding levels from $39 million to $45 million for FY'05 prior to reaching its recommendation of $41 million.

A $41 million borrowing level in FY'05 will allow the State to meet Moody's Investors Service's current and average five-year median of 2.2% for net tax-supported debt as a percentage of personal income in 2005, and will allow the State to continue lowering the total debt outstanding and annual debt service costs. The CDAAC believes that its recommendation will allow Vermont to appropriately balance the need to invest in state infrastructure with the need to continue to improve its State debt profile.

Proxy Voting and Corporate Responsibility

As fiduciaries for the State's pension funds and the State Trust Investment Fund, the trustees of the Vermont retirement systems and the State treasurer are required to act prudently and in the long-term economic interest of funds. The stocks purchased by investment managers for Vermont funds are assets that carry a voting responsibility that should be exercised consistent with required prudence. Shareholders have the opportunity to vote each year on certain significant issues that may affect the future financial performance of the company, such as disclosure, governance, compensation, mergers, or corporate business practices.

In practice, investment fund managers rarely attend the annual meetings where corporate actions take place. In most cases, investment managers send in their ballots, known as proxies. Currently, proxy-voting responsibilities are delegated from the retirement systems and the Treasurer's Office to external investment managers with very little guidance. Research compiled by the Treasurer's Office has indicated that votes are often inconsistent and contradictory from one manager to the next. The retirement boards and the Treasurer's Office have adopted a new policy, which will have the Vermont retirement systems and the Office of the Treasurer develop explicit proxy voting guidelines, request managers to vote their proxies according to those guidelines, and implement a process for monitoring how managers actually vote these proxies. The boards of trustees for each system have voted to adopt such a plan and are working with the Office of the Treasurer to prepare joint proxy voting guidelines for use in the next cycle of corporate annual meetings.

In my capacity as State Treasurer, I have worked with the National Association of State Treasurers to adopt resolutions in support of a number of specific corporate governance reforms. Institutional investors, such as state and local government pension funds, now own 60% of all the equity in US corporations and thus have the greatest exposure to the risks of poor corporate practices. Although Sarbanes-Oxley and other regulatory changes that have occurred since the corporate scandals involving Enron and WorldCom will make a difference, having the shareholder owners of corporations weighing in may more effectively convince offending corporate executives and board members to exercise increased diligence. A sample of the reforms supported by the National Association of State Treasurers includes the reporting of stock options as an expense in the same year that they are granted, the elimination of government financial incentives allowing American corporations to reincorporate overseas, and creating a practical process for shareholders to be able to nominate members to corporate boards of directors.

In November I joined with eight other state and city treasurers and comptrollers at the United Nations to issue a 10-point "Call for Action" to the US financial community for increased disclosure and analysis of the risks posed by climate change to institutional and individual investors. The nine officials represent public pension funds totaling more than one trillion dollars. Besides Vermont, the state treasurers and comptrollers from California, Connecticut, Massachusetts, Maine, New Mexico, New York City, New York State, and Oregon formed the "Investor Network on Climate Risk" to continue their joint actions on this issue. I believe that over the long term, climate change and global warming pose significant dangers to investors and whole economies. As a trustee of Vermont's pension funds, which are long-term investments, and as a state official concerned with protecting Vermont's financial future, I am compelled to do my part to encourage companies to analyze and disclose potential risks and liabilities in this area. As part of this effort, I supported a petition to the Securities and Exchange Commission (SEC) for enforcement of environmental risk disclosure requirements.

Unclaimed Property Dormancy and Demutualization

In 2003, I worked with the Legislature to revise Vermont's unclaimed property laws in order to improve our ability to reunite Vermonters with lost financial property. One significant change accelerated the process by which private holders of unclaimed property transfer lost items like stocks, bonds, insurance policies, and bank CDs into State custody. Under the previous law, most types of unclaimed property had to be forwarded to the Treasurer's Office after a five-year "dormancy" period. The legislation reduced that holding period to three years, as is the case in several other states. The legislation also revised the unclaimed property process for demutualized insurance companies. "Demutualization" occurs when an insurance company converts from a mutual form of ownership to a stock-based company. Under prior law, the dormancy period in such situations began when that conversion took place. With the recent change, the dormancy period before lost property is turned into the State as "unclaimed" is now three years after the earlier of the date of last contact with the policyholder *or* the demutualization date. Given that the vast majority of policy holders who failed to claim such distributions lost contact with the insurance company years, if not decades, prior to demutualization, there is no public policy reason for delaying the reporting and delivery to the State of unclaimed demutualization proceeds. Based on these changes, the Treasurer's Office estimates that an additional one-time $4,750,000 will flow to the general fund in FY'04. At the same time, consumers will have earlier access to their unclaimed property through concerted outreach efforts to the prospective claimants.

Pension Investment Results

The State Treasurer's Office administers the investment policies and strategies adopted by the Boards of the Vermont State Employees' Retirement System, the Vermont State Teachers' Retirement System, and the Vermont Municipal Employees' Retirement System. The three systems had combined net assets of more than $2.2 billion on June 30, 2003. Net assets consist of cash, receivables, investments, appreciation, and prepaid expenses, less any liabilities. These net assets increase or decrease over time depending on investment returns and employer and employee contributions, less benefits, refunds and operating expenses. While asset levels declined in fiscal years 2001 and 2002, largely due to disappointing investment returns consistent with the national trends in pension portfolios, I am pleased to report that this trend has reversed itself. In fiscal year 2003, the returns were 5.6% for the Vermont State Teachers' Retirement System (VSTRS), 4.6% for the Vermont State Employees' Retirement System (VSERS), and 1.9% for the Vermont Municipal Employees' Retirement System (VMERS). On a calendar year basis, I expect returns for the three funds will be in excess of 15% in 2003. For the ten years ended June 30, 2003, the median public retirement plan in the United States had an average annualized total return of 8.5%, compared with 8.7% for VSERS, 9.5% for VSTRS, and 9.6% for VMERS. Over the long term, Vermont's systems have outperformed the majority of national public pension plans.

Concerns Over Pension Underfunding

While pension investment returns have rebounded, a significant problem exists with chronic underfunding of the Vermont State Teachers' Retirement System. For several years, state contributions paid into the Vermont State Teachers' Retirement System (VSTRS) have been significantly less than actuarial recommendations. For FY'03, the actuarially required annual State contribution was $28,279,810, but the actual appropriation was $20,446,282. For FY'04, the actuarially required State contribution was $41,658,946, while the actual appropriation was again $20,446,282. For FY'05, the actuarial recommendation is $43,592,332.

Continued underfunding will simply have the effect of increasing the unfunded liability and increasing the pension burden for future generations of taxpayers. Since the unpaid contributions will not have been invested as assumed, lost investment earnings will also need to be repaid. For each $1 million in contribution shortfall, total additional contributions of $1.25 million will be required (basically, an additional 25¢ for every $1 of shortfall), further adding to the future burden.

Actually, taxpayers in Vermont are already bearing the burden of past underfunding. The 2003 recommended contribution rate of 9.53% would be about 6.22% if additional funding were not required to make up the prior shortfalls. This translates to an additional recommended contribution amount of over $14 million for FY'04 because of past shortfalls.

Realizing that it may well not be realistic for the State to close the underfunding gap in one year, the Treasurer and the Board of the Vermont State Teachers' Retirement System have proposed to the Governor that an inflationary increase in base funding in FY'05 be combined with a first-in-line one-time $10 million appropriation earmark from potential surplus revenues for three or four years beginning in FY'04. It is my hope the Governor and the Legislature will give serious consideration to this proposal or develop other strategies to meet the need for increased funding of the VSTRS system.

Acknowledgements

In addition to the initiatives noted above, there are many other changes that we have initiated during my first year in office, and we have many plans for continued improvements in future years. Many of these are reviewed elsewhere in the body of this report. I want to thank the hardworking and dedicated staff at the Office of the Treasurer for their support, education, and inspiration. I also want to thank the General Assembly, the Administration, and the Office of the Auditor of Accounts for their joint efforts in protecting Vermont's financial future. My staff and I are available to review the information in this report, and welcome your inquiries and/or comments.

Sincerely,

Jeb Spaulding

Jeb Spaulding
State Treasurer

About the Vermont State Treasurer's Office

Responsibilities

Under the direction of State Treasurer Jeb Spaulding, the Treasurer's Office is responsible for a wide range of administrative and service duties as prescribed by State statutes, including:

- Investment of State funds.
- Issuance of all State bonds authorized by the General Assembly.
- Serve as the central bank for State agencies.
- Management of the State's cash balances, processing of checks, and the reconciliation of payroll and vendor checks.
- Safeguarding and return of unclaimed or abandoned property (generally, various forms of financial property) being held in trust by the State until the rightful owner can be located.
- Administration of three major pension plans, the deferred compensation plan, and the defined contribution plan for State employees.

History

Treasurer Spaulding is a constitutional officer elected by the citizens of Vermont. Serving his first term, he took office in January 2003. He is the 29th Vermont Treasurer (see Exhibit #1). The first Treasurer was Ira Allen, the youngest brother of Ethan Allen. John A. Page served as the 10th (1853-1854) and the 13th (1866 to 1882) Treasurer. Madelyn Davidson, the first woman Treasurer, was appointed to fill a vacancy in 1968. Stella B. Hackel was elected in 1975.

The offices of Governor, Lieutenant Governor, Treasurer, Secretary of State, Auditor of Accounts, and Attorney General are elective offices. The first five are provided for in the constitution, while the Attorney General is provided for by State statute. Under the earlier State constitutions, Vermont elected only three State officers at large: Governor, Lieutenant Governor, and Treasurer, each for a term of a single year. In 1870 the term was extended to two years. In 1883, the Secretary of State and the Auditor of Accounts, who had previously been elected by the legislature, were added to the statewide ballot.

Mission Statement

The State Treasury manages money that belongs to all of the citizens of Vermont. The Treasurer and staff are committed to doing this honestly, efficiently, responsibly, and professionally. The Treasury operates as a business, serving the needs of Vermonters while working to save the taxpayers money and earn the highest possible return in its funds within acceptable risk parameters.

Protecting Vermont's financial future, we strive to:

- Be the best office of the treasury in the USA.
- Offer the best customer service possible.
- Do our part to make this office a great place to work.
- Give Vermont taxpayers an excellent value.

Exhibit #1

State of Vermont
State Treasurers

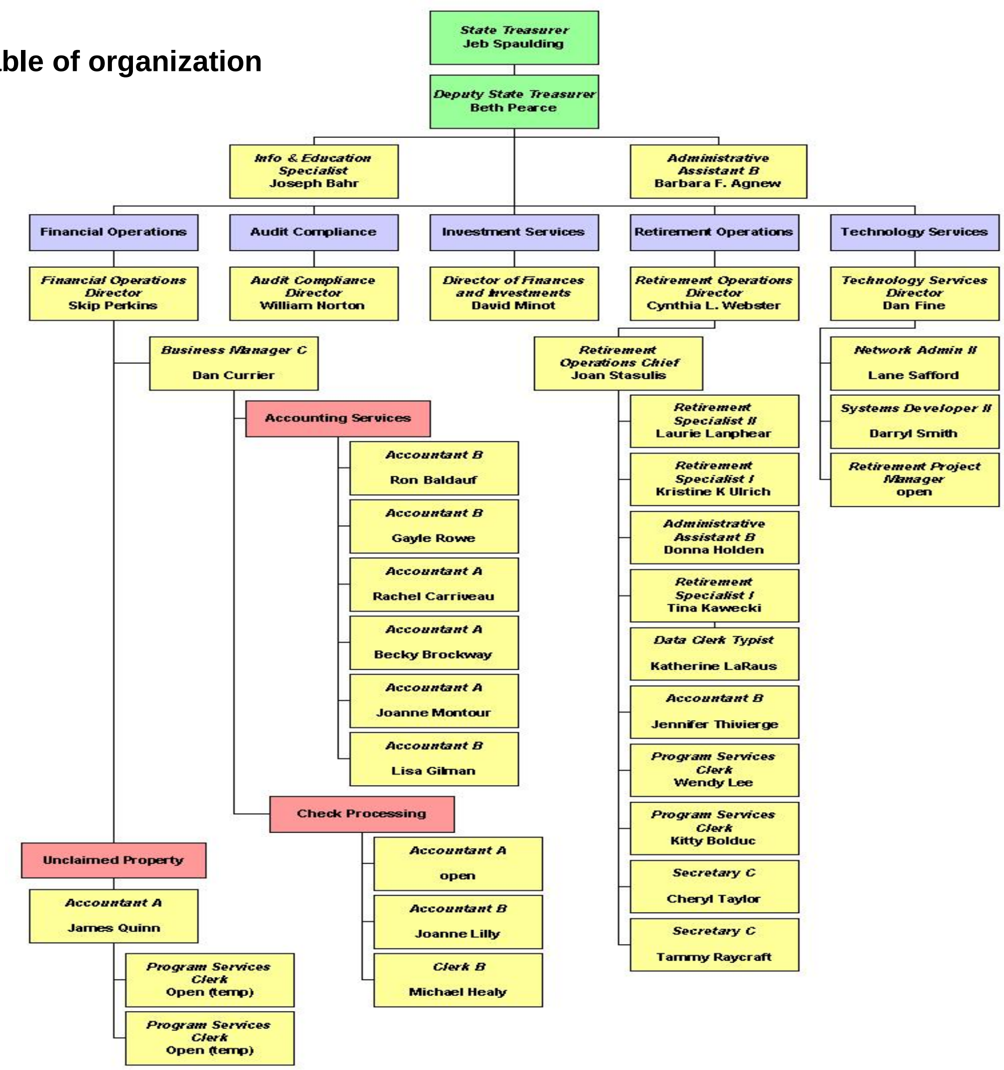
Ira Allen	1778-1786
Samuel Mattocks	1786-1800
Benjamin Swan	1800-1833
Augustine Clarke	1833-1837
Allen Wardner	1837-1838
Henry F. Janes	1838-1841
John Spaulding	1841-1846
Elisha P. Jewett	1846-1847
George Howes	1847-1853
John A. Page	1853-1854
Henry M. Bates	1854-1860
John B. Page	1860-1866
John A. Page	1866-1882
William H. Dubois	1882-1890
Henry F. Field	1890-1898
John L Bacon	1898-1906
Edward H. Deavitt	1906-1915
Walter F. Scott	1915-1923
Thomas H. Cave	1923-1943
Levi R. Kelley	1943-1949
George H. Amidon	1949-1965
Peter J. Hincks	1965-1968
Madelyn Davidson	1968-1969
Frank H. Davis	1969-1975
Stella B. Hackel	1975-1977
Emory A. Hebard	1977-1989
Paul W. Ruse, Jr.	1989-1995
James H. Douglas	1995-2003
George B. (Jeb) Spaulding	2003-

Prepared by Donald G. Milne, Clerk of the House

Administration and Organization

The Treasury is organized into an executive office and five divisions. The executive office is actively involved in the day-to-day management and supervision of all divisions, and is responsible for overall strategic planning, legislative initiatives, and constituent relations. Financial Operations is responsible for the state's banking, cash management, and financial transaction services. Finance and Investment Services directs debt management, short-term cash management, and long-term investment management for the State of Vermont and the three state-level pension systems. Information Technology is responsible for developing and maintaining automated systems, providing appropriate access to information, maintaining the Treasurer's Office Web sites, maintaining the office network and its security, and providing automated interaction with other departments and entities outside state government. The Retirement Division administers the three state-level public retirement systems, covering approximately 32,000 people. The Audit Compliance Division was created in 1999 to conduct independent reviews of financial operations and controls within the State Treasurer's Office. This division determines whether acceptable policies and procedures are followed, established standards are met, and resources are used efficiently and economically.

Table of organization



Vermont Retirement Systems

The State Treasurer's Office administers three statutory pension plans, with 23,691 active members and 8,925 retired members as of June 30, 2003. These are the Vermont State Teachers' Retirement System (VSTRS), the Vermont State Employees' Retirement System (VSERS), and the Vermont Municipal Employees' Retirement System (VMERS). Both VSTRS and VSERS are funded by employee contributions as well as contributions made by the State. The Vermont Municipal Employees' Retirement System is funded by employee contributions and local municipal employer contributions, and receives no State contributions.

For each system, a board of trustees is charged with the responsibility of general administration and proper operation of the retirement system. Pension investment functions and day-to-day retirement operations are administered through the State Treasurer's Office based on statutes, policies and guidelines adopted by the boards of trustees. The State Treasurer is a member of each trustee board.

In the past year there have been significant challenges and successes in the area of retirement benefits and pension investments. In a period of continuing corporate and investment scandals, the trustees have had to respond to an increasingly turbulent financial environment. The trustees have taken quick action as needed, and have taken significant positive steps relative to their fiduciary responsibility: the development of a proxy voting management plan and the endorsement of a concept to pool (unitize) the assets of three retirement systems to reduce costs and increase efficiency. These steps are discussed in detail in other sections of this report. Additional information on investment return and actuarial funding status is also included.

Vermont State Employees' Retirement System Board (VSERS)

The board comprises, by statute, the Governor or his designated representative, the State Treasurer, the Commissioner of Personnel, the Commissioner of Finance and Management, three members of the Vermont State Employees' Association (VSEA) who are members of the system, each elected by the Association, and one retired state employee who is a beneficiary of the system and is elected by the Vermont Retired State Employees' Association (VRSEA).

Left to right: Board Chair Warren Whitney and members Rob Hofmann, Dick Johannesen, and Bob Hooper.

Vermont State Teachers' Retirement System Board (VSTRS)

The board comprises, by statute, the Commissioner of Education, *ex officio*; the Commissioner of Banking, Insurance, Securities and Health Care Administration (BISHCA), *ex officio*; the State Treasurer, *ex officio*; two active teachers of the system elected by members of the system, and one retired teacher elected by the board of directors of the Association of Retired Teachers of Vermont.

Board of Trustees and Staff

From left to right: Retirement Operations Director Cynthia Webster; State Treasurer Jeb Spaulding; Education Commissioner representative Vaughn Altemus; teacher member Jon Harris, Vice-Chair; teacher member Joe Mackey, Chair; BISHCA representative Tom Candon; retired teacher Jay Kaplan; and Director of Finance and Investments David Minot.

Vermont Municipal Employees' Retirement System Board (VMERS)

The board comprises, by statute, a representative designated by the Governor, the State Treasurer, and two municipal employees and one municipal official elected by the membership of the system.

From left to right: Municipal Employer representative David Lewis; Municipal Employee representative W. John "Jack" Mitchell; Governor's Delegate Marie Duquette; and Municipal Employee representative Steve Jeffrey, Chair.

Retirement Division Operations

Administration of the Retirement Operations Division is conducted by the Office of the State Treasurer, under the direct supervision of the Director of Retirement Operations. The Retirement Operations Division currently comprises 12 staff members. The primary function of the staff is to serve the needs of the active contributing members and retired members receiving benefit payments. On the active member side, the Retirement Operations Division oversees enrollments, transfers, refunds, and adjustments to members' accounts. On the retiree side, the Division oversees the issuance of the payroll, changes to dependents, adjustments to payments, and replacement checks. Other responsibilities include employee re-instatements, calculation of buybacks and refunds, disability retirements, and determination of survivor benefits. There is an extremely high volume of inquiries by phone, e-mail, and face-to-face by appointment or walk-in. The retirement counselors provide one-on-one counseling to prospective retirees. Counselors provide estimates of pension and beneficiary payments by verifying a member's creditable service, salaries, and personal information (i.e., date of birth, beneficiary date of birth, etc.). Counselors and supervisory staff also conduct informational seminars. During the course of the calendar year, the Retirement Office conducted approximately 1,000 individual counseling sessions. It also conducted 46 informational sessions for members of the three systems, serving approximately 956 clients.

The Office also administers two defined contribution plans for State and Municipal employees that are offered as an alternative to the defined benefit plans. In addition, the Office administers a deferred compensation (457) program for State employees through a third-party administrator. A single depository investment account (SDIA), a tax-sheltered account funded through employee transfers from a non-contributing system, is also administered by a third-party vendor. Although the Retirement Division has contracted with a third-party administrator to handle the investment options and day-to-day bookkeeping responsibilities, the office is responsible for providing new hires with information and comparisons of projected benefits under both plans; it also conducts one-on-one counseling to assist in the election process. Staff members process all transfers between the plans, and receive and transmit all contributions on behalf of the defined contribution members.

The overall workload of the retirement staff has increased steadily over the years, as plans have increased in both complexity and number of members. The 'baby boomer' generation has already begun to retire. Over the next five years, the volume of retirements to be processed and maintained will mushroom. The information technology system needs to support the staff in ways the existing system was never designed to perform. The Retirement Division's legacy retirement system was written between 1976 and 1980, based on a design obtained from the State of Montana, and has been maintained and enhanced ever since by the Office of the State Treasurer's staff. It consists of about 60 COBOL programs running on the State's mainframe. There are three major components – active member administration, pension payroll administration, and a data collection and balancing subsystem.

The Retirement Division of the State Treasurer's Office is preparing to replace its automated mainframe-based retirement infrastructure with a modern and full-featured client server. The purpose of the new system is to provide the Retirement Division with the tools necessary to support an increase in the quality of service to the members and to provide time and cost-saving efficiencies to the staff. This includes faster turn-around for inquiries and requested services, easier access to needed information and documents, increased accuracy of information, and timely identification of problems.

The Board of Trustees for the Vermont State Retirement System administers a deferred compensation plan that has been available since 1973 as a savings option for State employees, municipal employees, employees of agencies such as VSAC, VEDA, and VHFA, and members of the General Assembly. In calendar year 2003, a plan participant under age 50 could defer up to $12,000 per year of his or her annual compensation and invest that money in one or more of the 15 mutual funds offered in the plan. On June 30, 2003, the plan had 4,789 State participants and 275 local participants for a total of 5,064 participants.

As of June 30, 2003, total assets in the plan were valued at $144.8 million. Participating employees made contributions to the plan in the amount of $13.38 million during FY'03. Because the deferred compensation plan qualifies as a section 457 plan under the Internal Revenue Code, the portion of salary that is deferred is not taxed at the time of deferral. The Board of Trustees for the Vermont State Employees' Retirement System adopted a policy to waive fees for new enrollees in the plan after January 1, 2001, for the first full year of enrollment. This is one way to encourage participation in a plan that decreases taxable income during active employment and increases savings for retirement.

After a competitive bid process, the third-party administrator of the plan was changed effective October 1, 2002, to Great West Retirement Services. As a result, fees for participants in the plan were lowered by ten basis points.

In 1998, the General Assembly offered active exempt State employees the option of remaining with their existing defined benefit plan or transferring their accrued benefits to a newly established defined contribution plan. Out of a pool of 806 eligible exempt employees, 349 (43%) elected to leave their State retirement defined benefit plan and transfer to the defined contribution plan whereby employees select from a menu of investment options. Exempt employees hired on or after January 1, 1999, are given the option of choosing between the two retirement plans. In 1999 the defined contribution plan was extended to terminated vested State members who were exempt employees at the time of separation from service. Of the 51 eligible vested members, 45 elected to transfer to the DC plan. The defined contribution plan has continued to grow in terms of total participants. At June 30, 2003, the plan had 551 participants and net assets of $26,920,943.

Under the defined contribution plan, which is modeled after private sector 401(k) plans, employees contribute 2.85% of their annual salary to their individual accounts. The State makes a fixed contribution of 7% to each employee's account. Employees are responsible for making all investment decisions among options selected by the Treasurer. At retirement or termination, employees receive the amount of contributions in their accounts, plus investment earnings. The defined contribution plan provides portability for an increasingly mobile workforce. It also reduces the unfunded liability for the State because the State does not assume the liability of a future pension benefit.

The Vermont Municipal Employees' Retirement System was given statutory authority in 1999 to approve a defined contribution plan for its members. The Board implemented a defined contribution plan on July 1, 2000. The plan provides the employer municipality with the first option of deciding whether to offer a defined contribution plan to its employees. Once a municipality elects to offer the plan to all eligible employees or to specific employment groups, an individual employee has the choice to remain with the defined benefit plan or transfer to the new defined contribution plan. New employees of municipalities offering both a defined contribution plan and a defined benefit plan will have a choice of either plan. During the first year, 62 employers offered the plan to approximately 800 employees. Two hundred, or 25%, elected to transfer to the DC plan effective July 1, 2000. As of June 30, 91 municipalities had offered the plan, with 447 participants and net assets of $5,775,959.

Pension Operations and Funding

The contributions made to the pension trust funds, in combination with investment return, largely fund the operations of the retirement plans including benefits, insurance (teachers' and state employees' systems), and administrative expenses. The results of operation for the three systems are reported in detail in Appendix A of this report. Chart #1 is a synopsis of operations at a summary level. In FY'02, the combined results of the three defined benefit plans resulted in a reduction in net assets of $142,560,877. The major contributor was poor investment performance. In fiscal year 2003, investment return rebounded, as indicated previously, and an addition to net assets totaling $81,571,561 was realized.

Based on measures established by the Governmental Accounting Standards Board Statement (GASB) No. 25, the funding status of the State Employees' and the Teachers' Retirement Systems has improved (Chart #2), although the two largest systems remain actuarially underfunded. The General Assembly has appropriated less than the actuary's recommended contribution to the Teachers' System throughout the past decade. Graph #1 shows the historical funding status for all three systems, based on GASB 25.

For several years, state contributions paid into the Vermont State Teachers' Retirement System (VSTRS) have been less than the actuarial recommendations. In fiscal years 1991 through 1999, the amounts of annual shortfalls were substantial.

Chart #1
Pension Operations Summary
Year Ended June 30, 2003

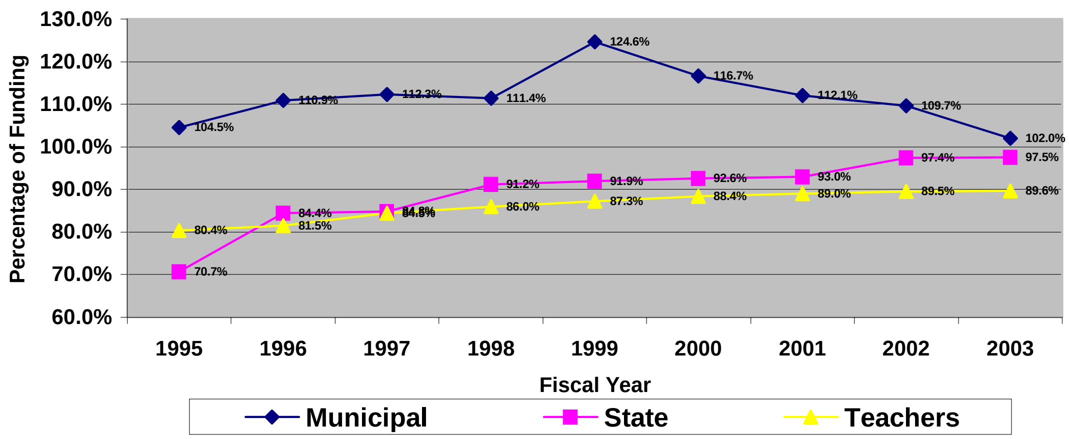
Category	State Teachers' Retirement System of Vermont	State Employees' Retirement Fund	Municipal Employees' Retirement Fund
SOURCES OF FUNDS			
Employee Contributions	$18,820,703	$12,171,186	$5,000,479
Employer Contributions	$20,446,282	$24,394,933	$5,707,184
Other Income	$438,166	$813,168	$17,855,452
Investment Income	$52,506,838	$40,435,216	$2,630,247
APPLICATION OF FUNDS			
Retirement Benefits	$50,409,313	$41,614,187	$4,929,747
Refunds	$1,109,174	$923,964	$639,170
Health/Life Insurance Expenses	$6,634,738	$9,916,398	$0
Administrative Expenses	$763,527	$971,394	$118,038
Other Expenses	$702,568	$369,383	$546,692
Addition to Net Assets Held in Trust for Pension Benefits	$32,592,669	$24,019,177	$24,959,715

Note: Municipal "other income" includes contribution for past service for two new municipalities.

Chart #2
Percent Funded Using GASB Opinion No. 25
Year Ended June 30, 2003

Category	State Teachers ' Retirement System	State Employees' Retirement System	Vermont Municipal Employees' Retirement System
Actuarial Value of Assets	$1,218,001,000	$1,025,469,000	$222,854,000
Actuarial Accrued Liability (AAL)	$1,358,822,000	$1,052,004,000	$218,533,000
Unfunded AAL (UALL)	$140,821,000	$26,535,000	($4,321,000)
Funded Ratio	89.60%	97.50%	102.00%

Graph #1
Status of Pension Funding Progress (Based on GASB Statement No. 25)



In fiscal years 2000 through 2003, the shortfalls were significantly lower than they had been in the preceding nine years. However, the absence of a firm commitment to refrain from underfunding, and the adoption of more conservative assumptions for the funding of the system (on the basis of a recently completed experience study) which are more consistent with national trends and increases in actuarially determined contribution levels caused by recent unfavorable investment experience have led to a return to the situation where the gap between the recommended State contribution to the System and the amounts actually appropriated is substantial, as a percentage of the recommended amounts.

Chart # 3 shows the extent of VSTRS underfunding through the fiscal year ending June 30, 2003. The total shortfall in contributions amounts to $111.26 million. This amount increases to $341.64 million when lost investment earnings on this amount are considered. The actuarial valuations treat the accumulated deficiency as a loss, and a portion of each year's recommended contribution goes to fund the deficiency. At this point, approximately $210.52 million of the total $341.64 million deficiency has been repaid through additional contributions and investment earnings on them, which leaves a deficiency balance of $131.12 million. The VSTRS has, therefore, about $131.12 million less in current assets than it would have had if the full contributions had been paid.

Continued underfunding will simply have the effect of increasing the unfunded liability and increasing the pension burden for future generations of taxpayers. Further, since the unpaid contributions will not have been invested as assumed, lost investment earnings will also need to be repaid. In fact, for each $1 million in shortfall, total additional contributions of $1.25 million will be required, basically an additional 25¢ for every $1 shortfall, further adding to the future burden. Taxpayers in Vermont are already bearing the burden of past underfunding. The 2003 contribution rate of 9.53% would be about 6.22% if additional funding were not required to make up the shortfall. This translates to an additional contribution of over $14 million for FY'04 because of past shortfalls.

Chart #3
Vermont State Teachers' Retirement System
Development of Funding Deficiency

Year ended June 30	Recommended Contributions	Contributions Paid	Deficiency	Accumulated Deficiency	Accumulated Deficiency with Interest
1979	$7,806,825	$4,825,155	$2,981,670	$2,981,670	$2,981,670
1980	8,944,090	8,471,960	472,130	3,453,800	3,678,916
1981	9,862,861	8,830,900	1,031,961	4,485,761	5,051,913
1982	10,200,209	7,822,760	2,377,449	6,863,210	7,887,571
1983	10,721,814	10,929,355	(207,541)	6,655,669	8,492,450
1984	12,341,069	11,592,100	748,969	7,404,638	10,266,458
1985	13,475,181	12,567,866	907,315	8,311,953	12,577,198
1986	14,668,095	14,461,148	206,947	8,518,900	14,729,838
1987	15,925,452	16,239,413	(313,961)	8,204,939	16,669,542
1988	16,294,346	17,186,259	(891,913)	7,313,026	17,347,900
1989	18,072,172	19,000,000	(927,828)	6,385,198	18,909,496
1990	21,320,155	19,561,000	1,759,155	8,144,353	22,593,638
1991	25,013,437	15,000,000	10,013,437	18,157,790	34,588,537
1992	28,595,220	14,618,992	13,976,228	32,134,018	51,331,848
1993	28,819,875	19,890,048	8,929,827	41,063,845	64,999,605
1994	25,805,408	20,580,000	5,225,408	46,289,253	75,203,983
1995	27,451,926	18,080,000	9,371,926	55,661,179	92,058,705
1996	28,490,673	11,480,000	17,010,673	72,671,852	119,527,247
1997	30,721,768	18,080,000	12,641,768	85,313,620	163,903,499
1998	26,927,205	18,106,581	8,820,624	94,134,244	198,276,678
1999	20,723,874	18,080,000	2,643,874	96,778,118	230,047,396
2000	21,703,161	18,586,240	3,116,921	99,895,039	263,714,611
2001	20,970,278	19,143,827	1,826,451	101,721,490	292,571,810
2002	22,146,880	20,446,282	1,700,598	103,422,088	313,903,976
2003	28,279,810	20,446,282	7,833,528	111,255,616	341,639,016*

* Approximately $210,516,932 has been repaid through additional contributions.

Source: Mellon Human Resources and Investor Solutions, actuarial consultants.

Debt Management

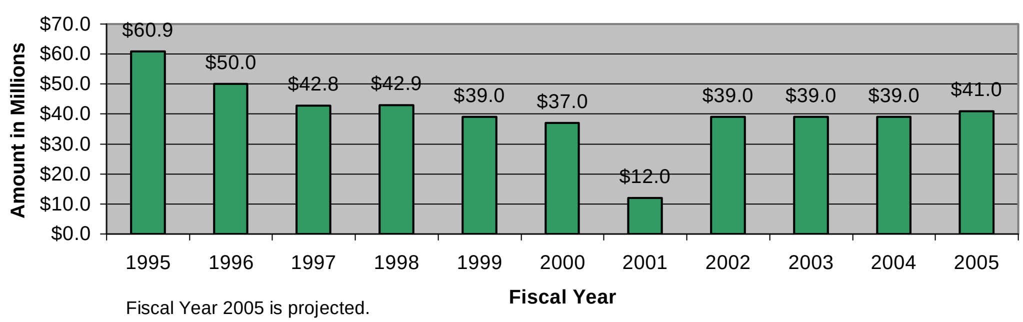
In recent years, Vermont has followed a course of modest levels of new long-term debt authorizations to reduce net tax-supported debt outstanding and improve the State's relative debt indices as measured by the major rating agencies. As a result, bond issuance is currently at substantially lower levels than in the early and mid-1990s.

The State reduced its new authorization for general obligation debt from $60.9 million in fiscal year 1995 to no more than $39 million from fiscal years 1999 through 2004 (Graph #2). Fiscal years 2000 and 2001 were lower than the long-term trend as a result of the application of one-time revenues in lieu of the issuance of debt. Approximately $2 million of revenues was used to pay for capital projects authorized in fiscal year 2000 (instead of the proceeds of bonds). Similarly, approximately $22 million of revenues was used to pay for capital projects authorized in fiscal year 2001.

This restraint and continued improvement in the State's economic indices and financial condition over recent years have helped to improve the State's debt ratios. The State's recent revenue surpluses have resulted in full funding of the State's budgetary stabilization funds for the General, Transportation, and Education funds over most of the recent fiscal years, and contributed to significant pay-as-you-go amounts being employed for funding capital improvements. In addition, the State's practice of issuing debt with level annual principal installments has resulted in a favorable amortization rate. At roughly 76% of debt retired within ten years, the State's bond payout ratio has been favorably received by the rating agencies.

A major contributing factor to Vermont's successful debt management has been the work of the Capital Debt Affordability Advisory Committee (CDAAC). The CDAAC completes an annual review of the size and affordability of the state tax supported general obligation debt, and submits to the Governor and to the General Assembly an estimate of the maximum amount of new long-term general obligation debt that prudently may be authorized for the next fiscal year. The recommendation of the committee is advisory, but historically has been adopted by the state. The CDAAC is made up of four *ex officio* members and one appointee of the

Graph #2
State of Vermont
Long Term Debt Authorizations, FY1995-FY2005



Fiscal Year 2005 is projected.

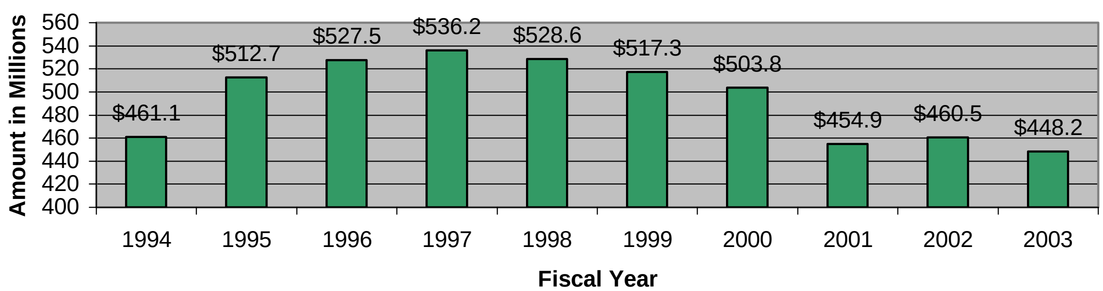
Governor. The State Treasurer serves as Chair of the committee.

From 1999 until this year, the CDAAC recommended no more than $39 million in new bonding each year. At its September 2002 meeting, the Committee agreed to consider building in an inflation factor in the future. The committee held a public hearing in August 2003 and considered several possible bonding levels from $39 million to $45 million for fiscal year 2005. In September 2003, the CDAAC met again, and recommended a $41 million authorization level for fiscal year 2005, encompassing a modest increase from prior years for inflation.

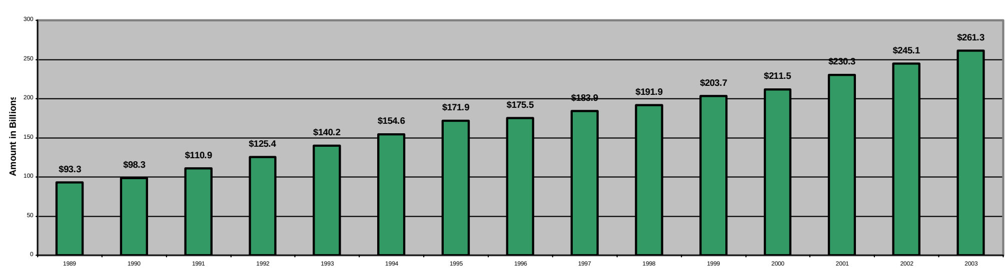
A $41 million borrowing level in FY'05 will allow the State to meet Moody's Investors Service's current and average five-year median of 2.2% for net tax-supported debt as a percentage of personal income in 2004, and will allow the State to continue lowering total outstanding debt and annual debt service costs. The CDAAC believes that its recommendation will allow Vermont to appropriately balance the need to invest in State infrastructure with the need to continue to improve the State debt profile.

By keeping new authorizations at a stable level, the State of Vermont has reduced its total level of outstanding long-term debt (see Graph #3). Net tax-supported debt outstanding reached a high of $536.2 million in 1997, and had been above the $500 million mark until fiscal year 2001. For June 30, 2003, net

Graph # 3
State of Vermont
Net Tax-Supported Debt Outstanding



Graph # 4
Total Net State (All States) Tax-Supported Debt Outstanding
Source: Moody's Investors Services

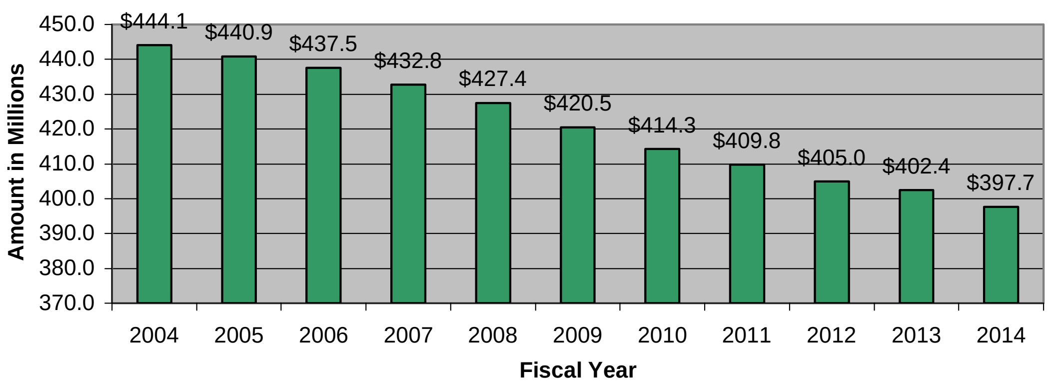


tax-supported debt outstanding has been reduced to $448.2 million. This is significant, given that the national trend (Graph #4) has seen a substantial rise in outstanding debt levels. Based on the current debt levels recommended by CDAAC, outstanding debt should continue to decline at a significant rate. The CDAAC report projects net tax-supported debt to decline by over 11% from 2003 to 2014 (Graph #5).

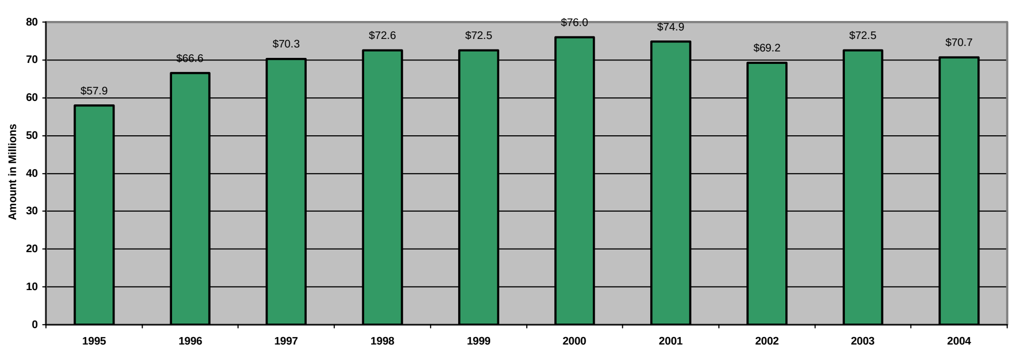
The total debt service, i.e., the amount appropriated to pay principal and interest on bonds, is calculated at $70.7 million for FY'04, down from $72.5 million in 2003 (see Graph #6). Future debt service payments will continue to fluctuate over the next decade and are not expected to show any steady decrease until FY'11, based on the current CDAAC model.

The State Treasurer's Office issued $30.8 million aggregate principal amount of general obligation bonds in December 2002, and $5 million in general obligation Vermont Citizen Bonds in January 2003. The combined total of $35.8 million left $3.2 million un-issued from the FY'03 authorization. The Treasurer's Office plans to issue this amount as well as the FY'04 $39 million authorization, for a total of $42.2 million in February 2004.

Graph # 5
Projected Outstanding Debt, FY 2004—FY2014



Graph #6
Net Tax-Supported Debt Service, FY 1995—FY 2004



The State took advantage of low interest rates and also issued refunding bonds in the amount of $31.6 million in December 2002. These bonds refunded the State's 1993 Series B General Obligation Bonds and resulted in a present value savings of 2.95%, or $942,909. An additional refunding of approximately $94 to $110 million, depending on market rates, is planned to be issued in February 2004.

Bond Ratings

Between September 1999 and September 2000, each of the three major credit rating agencies upgraded the State's general obligation bond rating. Vermont now enjoys the most favorable bond ratings in New England (Chart #4) and has avoided the downgrades experienced by many states in the past two years due to the economic downturn. Recent rating agency publications continue to look with favor upon Vermont's conservative debt management practices. Whenever the State of Vermont enjoys a higher rating, that rating enhances the marketing of its long-term debt. This generally results in a lower interest rate or cost of capital for borrowing. It is also likely to reduce borrowing costs for municipalities that issue debt through the Vermont Municipal Bond Bank, as well as enhance the State's reputation in the municipal marketplace.

Debt Statistics and Ratios

In assigning a rating to a State, the rating agencies have considered several key indicators. In 1995, the State, through the Capital Debt Affordability Advisory Committee, established guidelines for the State as acceptable ratios for these key debt factors. The Committee monitors the State's progress in meeting these guidelines annually and in formulating its recommendation of the total amount of long-term general obligation debt that the State can afford and should authorize each year. Several ratios continue to show improvement.

1. *Debt Per Capita*: One of the key debt measures monitored by the CDAAC is the ratio of the State's net tax-supported debt per capita. This guideline followed by the State establishes an acceptable ratio of debt per capita at $706 in 1995 dollars. Each year this figure is adjusted for

Chart #4
New England States: Bond Ratings

State	Moody's	S&P	Fitch
Connecticut	Aa3	AA	AA
Maine	Aa2	AA+	AA+
Massachusetts	Aa2	AA-	AA-
New Hampshire	Aa2	AA	AA+
Rhode Island	Aa3	AA-	AA
Vermont	**Aa1**	**AA+**	**AA+**

inflation. After adjustment, the guideline for FY'03 was $817, while the State's debt per capita ratio was $861, compared to $813 in 2002. The State's ranking declined from 18th to 16th. (The lower the ranking, the higher a state's debt per capita relative to all other states.) As a result, Vermont's ranking remains relatively high, with 34 states having less debt per capita than Vermont. The State's debt per capita ratio is compared to other New England states in Chart #5.

For FY'04, the State's projected debt per capita of $715 is below the inflation-adjusted target of $817 for this year. Assuming a steady level of authorization of $41 million in future years, and employing the population forecast developed by Economic Policy Resources, the State's net tax-supported debt per capita is forecast to decrease each year, and will be below the State guideline through 2014.

2. *Debt as a Percentage of Personal Income*: The State applies a guideline that the total amount of projected State debt should not exceed five percent of aggregate State personal income. The State has steadily improved in this area, as its ratio of debt to personal income for FY'03 dropped to 2.9% from 3.0% (Graph #7), the lowest level since 1990. The State's ranking in its debt as a percentage of personal income improved from the 10th highest among the states in 2000 to 14th in 2001 and 2002, and to 17th in 2003. The State's ranking in its debt as a percentage of personal income is compared to other New England states in Chart #6.

3. *Debt Service as a Percentage of Revenue*: In FY'03, the State remained in compliance with its established guideline with respect to a third key debt ratio – debt service as a percentage of revenues. The guideline used for this ratio states that projected annual State debt service on bonds should not be in excess of eight percent (8%) of projected revenues in the combined General and Transportation Funds during the next ten years. Debt service as a percentage of revenues ratio was at 6.8% as of June 30, 2003. This percentage is expected to decrease through 2014.

Chart #5

New England States: Net Tax-Supported Debt per Capita

State	Debt per capita
Connecticut	$3,440
Maine	471
Massachusetts	3,298
New Hampshire	485
Rhode Island	1,508
Vermont	**861**

Note: The data is based on data as of 12/31/02, *not* fiscal year-end.
Source: Moody's Investors Service

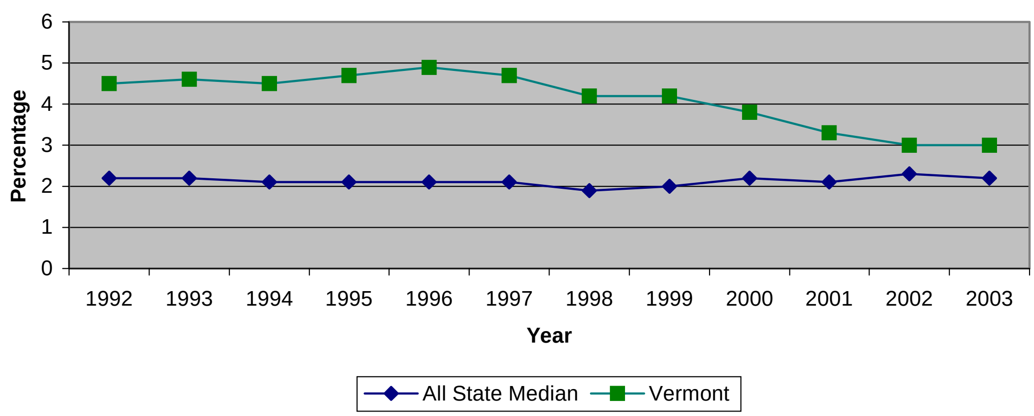
Chart #6

New England States: Net Tax Supported Debt as a Percent of 2001 Personal Income

State	Debt as a Percent of Personal Income
Connecticut	8.1%
Maine	1.7%
Massachusetts	8.4%
New Hampshire	1.4%
Rhode Island	4.8%
Vermont	**2.9%**

Source: Moody's Investors Service

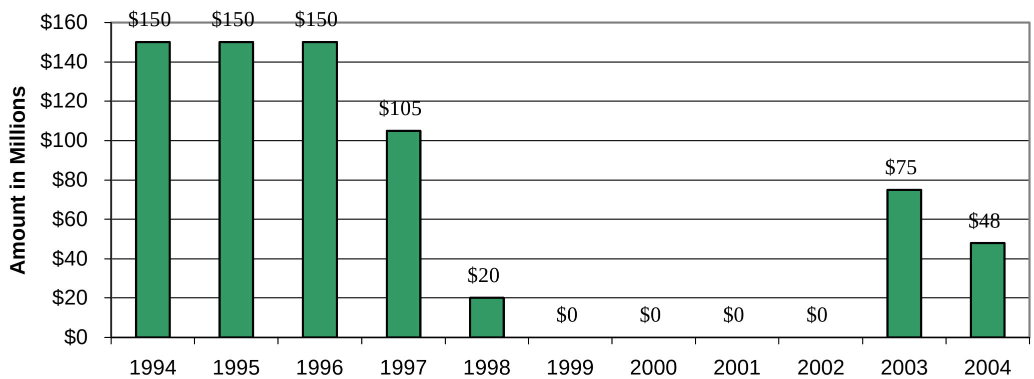
Graph #7
Net Tax-Supported Debt as a Percentage of Personal Income



Short –Term Borrowing

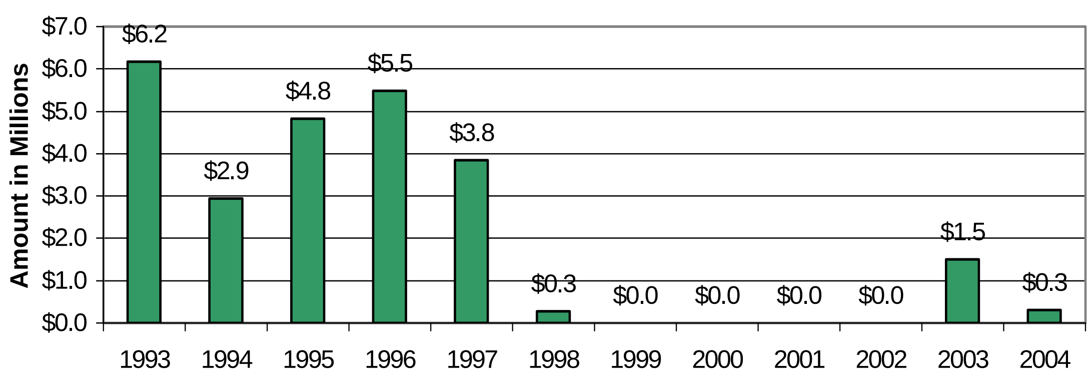
In the early 1990s, Vermont was issuing between $155 and $192 million of short-term debt annually, exclusive of deficit notes issued. The State's strong cash position did not require the issuance of short-term debt in fiscal years 1999-2002 (Graph #8). The rating agencies cited the reduction in short-term borrowing as a significant factor in their upgrades of the State's ratings. Besides the positive view held by the rating agencies, the State has saved significant money by avoiding interest charges on borrowed funds. As the national and regional economy placed additional stresses on governmental revenues, the State's cash position in fiscal year 2003 did necessitate the short-term borrowing of $75 million. The State issued $75 million in revenue anticipation notes that matured on June 16, 2003. The notes bore a coupon rate of 2.5% and debt service on the notes was $1.5 million. The State's cash position has, however, begun to improve. In FY'04, projected cash shortages, peaking in December, necessitated the borrowing of $48 million. On September 6, 2003, the State issued $48 million in revenue anticipation notes that mature on March 6, 2004, and carry a coupon interest rate of 1.18%. Due to this low interest rate and borrowing amount, as well as a relatively short borrowing period, interest on the notes is $283.3 thousand (Graph #9). The State's cash flow, despite this seasonal fluctuation, is expected to improve on a net basis, with a projected increase in non-restricted cash balances of $52.8 million from July 1, 2003, to June 30, 2004. As reserves are replenished over the next two fiscal years, the need for seasonal short-term borrowing is expected to continue to decline.

Graph #8
Short-Term Borrowing, FY 1994– FY 2004



* Projected

Graph #9
Interest Paid on Short-Term Borrowing, FY 1993– FY2004



* Projected

Investments

Pension Fund Investments

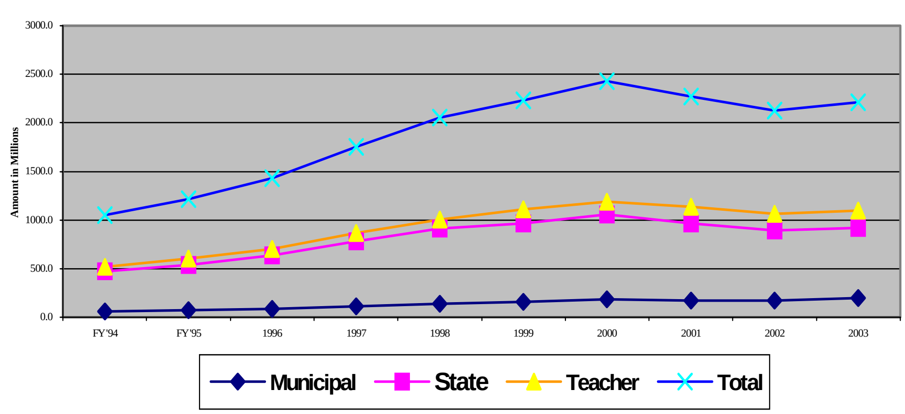
The State Treasurer's Office administers the investment policies and strategies adopted by the Boards of the Vermont State Employees' Retirement System, the Vermont State Teachers' Retirement System, and the Vermont Municipal Employees' Retirement System. The three systems had combined assets of more than $2.2 billion on June 30, 2003. While asset levels have continued to rise over the long term, they declined in fiscal year 2002, largely due to disappointing investment returns consistent with the national trends in pension portfolios. The growth in assets is displayed in Graph #10 below.

The fiscal year 2002 investment rate of return declined significantly (Graph #11). In fiscal year 2003 the returns rebounded, and rates of return were 5.6% for the Vermont State Teachers' Retirement System (VSTRS), 4.6% for the Vermont State Employees' Retirement System (VSERS), and 1.9% for the Vermont Municipal Employees' Retirement System (VMERS). Asset levels again began to increase, as investment return is a major contributor to the overall asset growth. In FY'03, net assets for VSTRS increased by 3.1%, VSERS by 2.7%, and VMERS by 14.5% (two large municipalities joined VMERS in FY'03 and transferred in assets of over $6 million to cover past service liabilities).

For the ten years ended June 30, 2003, the median public retirement plan in the United States had an average annualized total return of 8.5%, compared with 8.7% for VSERS, 9.5% for VSTRS, and 9.6% for VMERS. Over the long term, Vermont's systems have outperformed the majority of public pension plans.

Asset allocation is essential to the investment performance of the plan. In order to insulate the portfolios from short-term market fluctuations, the three pension systems diversify assets across a broad group of asset classes, which enables each portfolio to maintain stability through market cycles of the different asset classes. Each system's assets are invested in stocks, bonds, and real estate, with an additional small allocation to alternative

Graph #10
Growth in Pension Assets



Graph #11
Pension Funds, Investment Rate of Return

investments, such as venture capital partnerships. These investment categories have imperfect correlations, so if one category is faltering, another may be doing exceedingly well. This strategy minimizes the effects of short-term volatility that occurs within each asset class and is totally different from market timing, in which an investor attempts to predict the ups and downs of various markets. In such a strategy, substantial losses can occur if the timing decision is incorrect. Asset allocation accounts for a significant percentage of a fund's gains/losses. Chart #7 below identifies the actual asset allocation of the three pension funds as of June 30, 2003.

Graph #11
Pension Funds, Investment Rate of Return

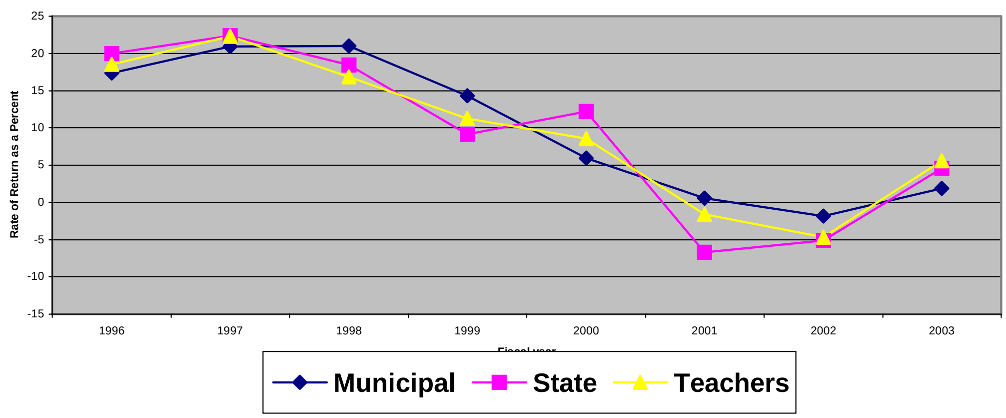


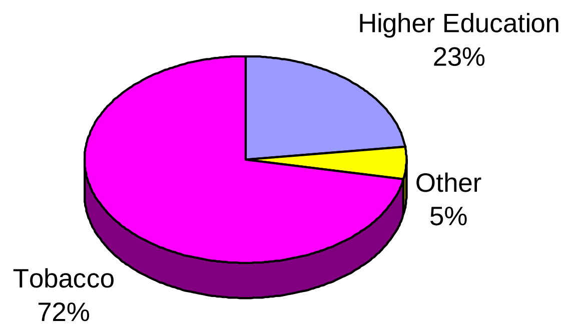
Chart #7
Asset Allocation of Pension Funds Quarter Ending June 30, 2003

Investment Category	Municipal	Teachers'	State
Domestic Equity	46%	45%	45%
Domestic Fixed Income	31%	18%	20%
International Equity	15%	17%	18%
Global Fixed Income	0%	11%	8%
Real Estate	7%	8%	8%
Other	1%	1%	1%

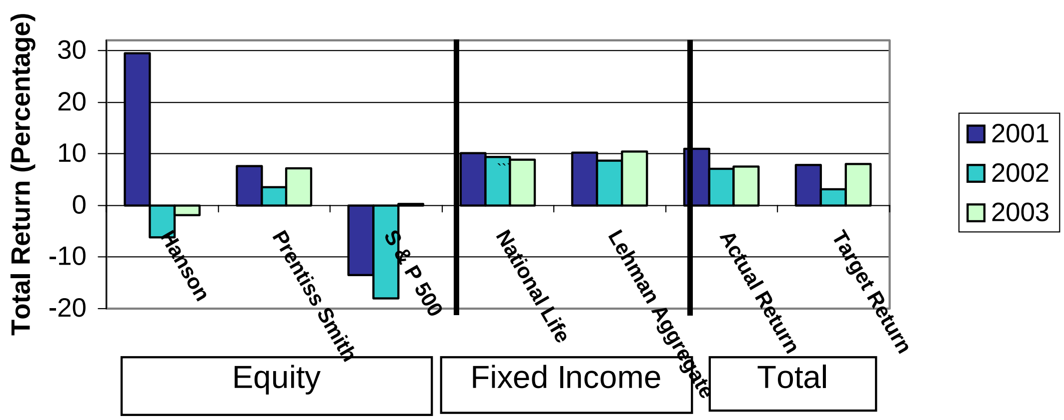
Trust Investment Account

The 2000 Legislature authorized the establishment of a trust investment account administered by the State Treasurer for purposes of investing restricted funds with non-expendable principal balances. As of June 30, 2003, the fund had a principal balance of approximately $37.3 million, of which $26.8 million was allocated to the Tobacco Trust Fund, $8.6 million to the Higher Education Endowment Trust Fund, and the remainder to various smaller trust funds. For FY'03, the fund had a total return of 7.47% versus the target return of 8.02%. For the same period, the S&P 500 Stock Index returned 0.3% and the Lehman Aggregate Bond Index returned 10.4%.

Graph #12
Trust Investment Account Breakdown as of June 30, 2003



Graph #13
Trust Investment Account
Total Return by Asset Class Fiscal Year 2001, 2002 and 2003



Higher Education Trust Fund

The 1999 Legislature established the Vermont Higher Education Endowment Trust Fund and appropriated $6 million for the creation and management of the fund by the State Treasurer. An additional $1 million was added to the fund in FY'01 and $635,881 at the end of FY'02. On June 30, 2003, the fund had a market value of $8,572,981. In August of 2003, the State Treasurer authorized the distribution of 5% of the average market value of the assets over the prior 12 quarters equally among the University of Vermont, the Vermont State Colleges, and the Vermont Student Assistance Corporation. Each received $123,931 to be applied as non-loan financial aid to Vermont students attending Vermont post-secondary institutions.

In addition to these disbursements from the fund, the Vermont Commission on Higher Education Funding authorized the Treasurer to make available an additional 2% distribution of $139,470 to be divided equally between the University of Vermont and the Vermont State Colleges for application to their respective permanent endowments. In FY'04, the additional endowment allocation will be $74,358 for each institution, provided that it is matched on a two-to-one basis by external donations for endowment purposes by the end of the fiscal year. A copy of the State Treasurer's Annual Report to the Commission is attached as Appendix B.

Tobacco Litigation Settlement Fund and the Tobacco Trust Fund

In 1998, Vermont was one of 46 states to enter into a Master Settlement Agreement (MSA) with four major tobacco companies. The State's estimated share of settlement payments at the time was expected to total $806 million over the first 25 years of payment and an additional $156 million of strategic contribution payments to be paid between 2008 and 2017. To date, the State has received payments that total $119,702,993.

Pursuant to the Agreement, the expected settlement amounts are adjusted for inflation and the effect of any decreases in the sale of tobacco products to the base year. To date, these have accounted for a 13% decrease. It remains difficult, therefore, to predict the amount of the future payments due from the tobacco settlement that will be received by the State.

In fiscal year 2000, the Vermont Legislature established a Tobacco Litigation Settlement Fund to be administered by the State Treasurer. All monies received by the State in connection with the MSA are deposited in this Fund. Monies are then transferred to other funds, subject to appropriation by the Legislature to support tobacco prevention, cessation, and control programs, and for other health care purposes. For fiscal year 2004, the Legislature appropriated $17.25 million (the same as fiscal years 2001, 2002, and 2003) to health care services, and $5.2 million to programs in the Health and Education Departments.

Chart #8
Vermont's Expected and Actual Receipt of Settlement Funds ($ Millions)

Year	Expected	Actual
Fiscal year 2001	$28.47	$ 24.68
Fiscal year 2002	34.18	31.14
Fiscal year 2003	34.51	30.63
Fiscal year 2004	28.80	25.20*
Fiscal year 2005	24.83	NA

* Estimated

Additionally, $2.2 million was appropriated to substance abuse and youth protection programs in the Agency of Human Services. In addition, the Tobacco Trust Fund was established to create a long-term fund not dependent on tobacco sales volume. It generally receives the unencumbered balance from the Tobacco Litigation Settlement Fund at year end. Such remaining receipts were transferred to the Tobacco Investment Trust Fund at the end of FY'00, FY'01, and FY'02. The receipts remaining at the end of FY'03 were not transferred to the Tobacco Investment Trust Fund but were instead transferred to the Health Access Trust Fund. The trust's assets are invested in the Trust Investment Account. The Tobacco Trust Fund balance at the end of fiscal year 2003 was $26.8 million**.**

Vermont Veterans' Home

By legislative act, the Vermont Veterans' Home was required to transfer its endowment fund to the State Treasurer. In the fall of 2001, the Home transferred $455,441 to the State. The legislation allows the State Treasurer to invest these funds, if appropriate, with the long-term investments in the Investment Trust Account. The funds were invested with the State's short-term investments until a spending policy for these funds was established by the Board of Trustees for the Vermont Veterans' Home. At its September 2002 meeting, a spending policy was adopted that allowed for transfer of the funds to the Trust Investment Account. Of the amount transferred to the State Treasurer, $400,000 was deposited into the Trust Investment Account; $43,941.85 was deposited to the Veterans' Donation Fund; and the balance remained in the endowment fund outside of the Trust Investment Account. These funds were deposited as of October 1, 2002. In November and December of 2002, the Vermont Veterans' Home received a bequest of $410,000 that was deposited into the Trust Investment Account as a separately named fund pursuant to the terms of the bequest.

As of June 30, 2003, the first contribution to the Trust Investment Account of $400,000 increased to $434,880, and the second contribution of $410,000 increased to $430,574, for a total of $865,454. Returns on each contribution were dependent upon amount deposited, time of deposit, and market conditions. Based on investment performance and time of deposit, a request was made to the Commissioner of Finance and Management to make an expenditure of $25,000 from the Endowment Fund, which was approved following the end of FY'03.

Short-Term Investing

The State Treasurer manages the investment of the State's cash in its short-term investment program. The short-term portfolio earned over $2.0 million in interest income in FY'03 on average daily balances of $148 million. Of this amount, $915,668 was transferred to the general fund. Short-term earnings were down considerably from the level of FY'02, principally due to historically low interest rates. The yield on the portfolio was 1.36% for the year, which is 0.08% higher than the average three-month treasury bill auction rate of 1.28%. The Treasurer's Office solicits offerings daily from the institutional trading desks of dozens of national and local brokers in order to achieve maximum rate of return and diversification in the portfolio.

Financial Operations

The Financial Operations Division directs all money movement within the State. There are 23 core State bank accounts in two banks, five pension/retirement accounts, and two deferred compensation accounts from which funds are moved to fund the various transactions of the state. In addition, there are approximately 250 agency bank accounts for which this division exercises oversight.

This division, in concert with the Director of Finance and Investments, acts as the State's banker. This involves moving funds to cover payroll, vendor, and other disbursements, transferring receipts to interest-bearing accounts and investment instruments as quickly as possible to maximize return, and projecting cash needs so that fund movements can be efficient and cost effective. This involves the movement of over $3.6 billion in both net receipts and disbursements annually. This division also exercises administration over the Unclaimed Property Division (see next section).

In addition to moving the funds, this Division has significant responsibility with respect to the integrity of the State financial management systems. The movement of cash interacts with accounting. It is critical that staff members in the Division understand the accounting and financial management implications of their activity, and properly record them in the VISION system. In addition, staff members provide guidance and consultative service to all State agencies and departments that deposit funds into State accounts at commercial banks to ensure that all receipts of the State are deposited and accounted for in a timely and accurate manner. When the State made a change to the VISION system, it also necessitated a change in the accounting knowledge necessary to support the new system. Treasury staff training, knowledge, and skills have been upgraded, not only to meet our own business requirements but to assist the user agencies.

The many new stresses and demands have changed the workload and complexity of the Division, in addition to the accounting functions. The banking environment has been changed by economics and bank mergers, and also by the changing role of electronic processing -- electronic funds transfers, automated clearing house (ACH) transactions, debit/credit card transactions, etc. There are operational and regulatory (banks, NACAH rulemaking, Federal Reserve) requirements associated with the changing industry, and it is incumbent on this Division to stay current with these and to work collaboratively with its business partners (Finance and Management, Tax, and Payroll).

Electronic Payments

The State Treasurer's Office encourages electronic transmissions of such items as vendor payments, payroll, welfare, and other benefits. Most payments to municipalities are now handled electronically. In fiscal year 2003, the Treasurer's Office processed approximately 1.6 million payments; 27.5% were electronic transfers. Our goal continues to be to increase the proportion of financial transactions that occur electronically. The Treasurer's Office continues to encourage State employees and retirees to authorize direct deposit of their paychecks and retirement checks.

Direct deposit is a more efficient, less costly, and safer method by which to transfer funds. In December of 2003, 79% of retired municipal employees, 88% of retired State employees, and 91% of retired teachers received their monthly benefit payments via direct deposit. This is an increase from the December 2002 percentages of 78%, 87%, and 90% respectively. Currently 7,165 State employees, or 78%, have their biweekly pay deposited directly to their bank accounts.

Reconciliation

The Office has made significant progress in resolving an issue with bank reconciliation. As noted in previous audit findings, there were significant reconciling items, on the book side of the systems, as of June 30, 2002. The combination of the transition to the VISION system and, at the same time, the movement of the State's primary bank accounts to a new bank resulted in a number of procedural changes for the Office of the State Treasurer and the various user departments/agencies. The book balance, as recorded by VISION, had numerous problems that required resolution. The accounting system in place prior to VISION was centralized in the Department of Finance and Management.

VISION is a decentralized system that transfers much of the responsibility for entry of revenues and expenditures to the user departments/agencies. As noted in the report by Mudgett Jennett & Krogh-Wisner, "Upon installation of any new accounting system there is an expected period of errors and corrections while accounting staff learn to use the new software. When VISION was implemented, errors were introduced by the decentralization of the general ledger posting function. Activity posted to the general ledger system was, at the outset, prone to error and poorly documented, making reconciliation difficult."

The Office of the State Treasurer and the Department of Finance and Management have taken proactive steps to reduce the risks and improve the integrity of the data, timeliness, and reporting tools in the various systems. While the Treasury has clearly experienced a painful transition period, it has made significant progress in resolving these issues.

The engagement of a consulting CPA firm, Mudgett Jennett & Krogh-Wisner, P.C., to review our procedures and recommend improvements was a significant initial step. A series of joint reviews of the reconciliation process with the Department of Finance and Management assisted the Office of the State Treasurer in resolving important procedural and system issues.

A more formal tracking system to review reconciliation progress is now in place. Tracking of bank accounts has indicated that by March 2003, many of the accounts were reconciled within 30 days of the monthly accounting close. Reconciliation timeliness has continued to improve, and as of November 2003, all Treasury bank accounts are current; we plan to maintain a target of completion within 30 days from the close of the accounting period.

Banking

Banknorth Vermont continues to serve as the State's master banking contractor. Bank personnel have worked thoughtfully and diligently with Treasury staff to provide secure and efficient services to the State. In

FY'03, the Treasurer's Office and Banknorth implemented a positive pay service that not only provides an additional tool to detect potential fraud and forgeries on State checking accounts but also detects, on a daily basis, encoding and posting errors by the Bank in the State's accounts, thereby reducing the number of reconciling items each month.

Additionally, the Treasurer's Office is now connected with Banknorth Group, Inc. through the World Wide Web. A new and innovative Internet online banking service, eCash Manager, was launched in the spring of 2003. It allows Treasury personnel to access up-to-the minute account information, initiate wire transfers, perform automated transfers of funds, process stop payments, and review reporting functions, check services, and secure messaging to improve cash flow forecasting and funds management.

Act 68 Receipts

The Treasurer's Office monitors and collects local payments mandated by Act 68 after the Departments of Education and Taxes have notified towns and school districts of their respective liabilities. In FY'03, all towns and school districts made their Act 68 payments.

To date, all districts except three have made their Act 68 payment that was due on December 1, 2003. The Treasurer's Office is in the process of conferring with the delinquent entities to encourage compliance and to collecting interest on the late payments. As in the past, unresolved delinquencies will be referred to the Attorney General for collection.

Unclaimed Property Division

The primary function of the Unclaimed Property Division is to locate and return various forms of financial property (and equivalents) to the rightful owners or their heirs. This property is most often in the form of cash, but it can also be stocks, mutual funds, and contents of safe deposit boxes. This property comes from many sources including banks, credit unions, corporations, utilities, insurance agencies, retailers, and governmental agencies throughout the United States. The State of Vermont acts as custodian to safeguard the assets until they can be claimed by the rightful owners or their heirs.

Currently, the State Treasurer holds more than $19.0 million of unclaimed property. In FY'03, holders of unclaimed property turned over $3.3 million to the Unclaimed Property Division. Over the last nine years, Unclaimed Property receipts have increased from less than $1 million to an average of over $3.5 million for the past four years. This division has stepped up its outreach program to holders. Holder information is now posted on the Treasurer's Web site and holders are able to print out reporting forms. The Unclaimed Property Division paid a total of $1.543 million in claims in fiscal year 2003. The average claim paid was $543.50; the largest claim paid was $105,345.

Vermont makes a diligent effort to locate missing owners and reunite them with their lost assets. The help of town clerks and state legislators has been enlisted and the names of owners have been posted on the Internet. Users of the State's Web site have the ability to download reporting and claim forms. Thousands of "owner" letters are sent each year. The office staffs a booth at the Champlain Valley Fair as an outreach activity to potential claimants. As a result of staffing efforts at this year's Exposition, 248 people obtained claim forms for a total of $41,341.00, based on applications made at the booth. Owners' names are published annually in newspapers around the State, as required by statute. Vermont also participates in reciprocity agreements with other states in an effort to return abandoned property to the state in which the owner most recently resided. This practice also allows holders to report only once instead of reporting to multiple states.

The Vermont General Assembly enacted legislation in 2003 that entailed a number of revisions to Chapter 13 of Title 27 regarding Unclaimed Property. The two most prominent amendments relate to the reduction in the dormancy period for most types of property, from five years to three years, and the development of special provisions directed at demutualized insurance companies. The effects of these legislative revisions will significantly improve the prospect that the unclaimed property in question will be reunited with its rightful owner.

Under the previous law, most types of unclaimed property had to be forwarded to the Treasurer's Office after a five-year "dormancy" period. The legislation reduced that holding period to three years, as is the case in several other states. The legislation also revised the unclaimed property process for demutualized insurance companies. "Demutualization" occurs when an insurance company converts from a mutual form of ownership to a stock-based company. Under prior law, the dormancy period in such situations began when that conversion took place. With the recent change, the dormancy period before lost property is turned into the State as "unclaimed" is now three years after the earlier of the date of either the last contact with the policyholder or the demutualization date. Given that the vast majority of policy holders who failed to claim such distributions lost contact with the insurance company years, if not decades, prior to demutualization, there is no public policy reason for delaying the reporting and delivery to the State of unclaimed demutualization proceeds. Based on these changes, the Treasurer's Office estimates that an additional $4,750,000 will flow to the general fund revenues in fiscal year 2004. At the same time, consumers will have earlier access to their unclaimed property through concerted advertising efforts to reach the prospective claimants.

In November 2003, the unclaimed property software system was replaced with a Windows product called Unclaimed Property Management System (UPMS). UPMS is the most comprehensive and state-of-the-art system available for unclaimed property administration. Some of the highlights of the system include: the ability to interact with Web sites, the ability to import holder and owner data from external sources, the ability to interface with VISION, and enhanced reporting and tracking features. We expect these innovations to significantly improve our outreach activities and reduce the turnaround time for processing claims.

Audit Compliance

Internal audit and control is broadly defined as a process, affected by an organization's management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

1. Effectiveness and efficiency of operations.
2. Safety of assets.
3. Reliability of financial reporting.
4. Compliance with applicable laws and regulations.

Internal controls are tools that help managers be effective and efficient, while avoiding serious problems such as theft, fraud, and mismanagement of resources, overspending, operational failures, and violations of law. Internal controls are the structure, policies, and procedures put in place to provide reasonable assurance that management meets its objectives and fulfills its responsibilities.

Since its creation five years ago, the division has conducted independent reviews to determine whether acceptable policies and procedures are followed, established standards are met, and resources are used efficiently and economically in reaching the organization's objectives.

This is the second year of the new accounting system, VISION. Given the decentralized nature of the VISION system, this necessitated a fresh look at internal procedures and controls at both the Treasury oversight and user department levels. The Division has been active in reviewing, revising, and improving operations along with the accounting staff and the Department of Finance and Management. The Division continues to perform a post-audit of the office's expenditures on a daily basis and is active in resolving variances in the bank reconciliation process.

The Division also plays a key internal control role with the Accounting Division in reviewing the more than 250 departmental cash accounts. A format for controlling these accounts has been implemented and additional financial disclosure has been prepared for the State's Comprehensive Annual Financial Report (CAFR). Our review includes an assessment of the agency internal controls for reconciliation.

In addition, the Division has been actively involved in reviewing the work performed by the State's pension custodian, verifying data for incorporation in the state's VISION system. This includes review of the pension financial statements that must conform to GASB standards.

This year the Treasury conducted its first "death check" of the pension system retirees. This is essentially a match of death records to the active participant listing to identify potentially fraudulent claims. We examined information on 8,835 retirees as well as 1,429 vested, terminated employees. We found 12 deceased retirees whose accounts were still receiving monthly benefits. This resulted in $6,484 in monthly payments being cancelled. We also found that 17 vested, terminated employees were deceased, and 22 invalid social security numbers were identified as part of the date clean-up procedure. Overpayments made to the 12 deceased retirees totaled $140,309; those monies have been collected or are in the process of litigation through the Office of the Attorney General. A more effective verification procedure has been established.

Legislative Reporting Requirements

Brandon Training School

Section 23 of Act 62 (the so-called Capital Bill) of the Public Acts of 1995 requires that the State Treasurer notify the chairs of the Senate and House Institutions committees upon receipt of monies from the sale of the Brandon Training School property. Property belonging to the Brandon Training School was sold for $197,353 in FY'03.

MacBride Principles

Act 50 of the Public Acts of 1989 specifies that the State Treasurer and the Retirement Boards compile a list of corporations that conduct business in Northern Ireland in which the State Treasurer and Retirement Boards have invested funds. Notification from external investment managers is due in the Treasurer's Office on January 1 of each year and is available for examination in the State Treasurer's Office. The Act further requires that the Treasurer and the boards of trustees of the Vermont State Teachers' Retirement System and the Vermont State Employees' Retirement System shall support MacBride principles, which address worker equality and safety issues, through support of shareholder resolutions. The Treasurer's Office and the trustees comply with Act 50 by mandating MacBride Principles compliance through investment guidelines that must be observed by investment managers. Proxy voting guidelines to be developed and adopted by the Treasurer and these retirement systems in FY'04 will also specify manager proxy voting compliance with MacBride Principles and will monitor any exceptions.

Burma (Myanmar)

Act 13 of the Public Acts of 1999 specifies that the Treasurer shall implement the purposes of the Act by voting in favor of shareholder resolutions concerning an individual company's doing business with the government of Burma. In addition, the Treasurer shall separately notify the company that Vermont wishes to convey its grave concerns regarding the company's economic ties to the government of Burma. The Treasurer complies with this Act through measures including mandating compliance through investment guidelines that must be observed by investment managers. Proxy voting guidelines to be developed and adopted by the Treasurer and the Vermont retirement systems in FY'04 will also specify manager proxy voting compliance with the Act, and will monitor exceptions.

Firefighters' Survivor Benefits

Act 119 of 2002 established a Firefighters' Survivors Benefit Review Board, effective July 1, 2002, to administer the grant of a one-time monetary benefit to the survivor or survivors of a firefighter who dies in the line of duty or of an occupation-related illness. Administrative support for the Board was assigned to the State Treasurer's Office.

This was the first full year of existence for the Firefighters' Survivors Benefit Review Board. The Board met three times, developing and adopting policies, forms, and procedures to carry out its task. The Board also paid its first benefit award. The award of

Legislative Reporting Requirements (continued)

$50,000 was paid to the widow of a firefighter who died while responding to a call in Middlebury.

Although the fund currently contains $100,000, the Board is requesting an additional $50,000 of funding in the current budget application. In the past, Vermont has experienced fire disasters that took the lives of several firefighters in the same year. Therefore, the Board considers it prudent to provide for such a tragic possibility.

Credit Card Payments

Act 61, relating to the statewide acceptance of credit and debit card payments, was enacted into law during the 2003 legislative session. The Treasurer's Office has negotiated with and awarded a contract to Banknorth Merchant Services Group, a division of Banknorth Group, Inc., to provide merchant bankcard services to the State of Vermont. The Treasurer's Office assisted each agency and department that had prior statutory authority with the conversion. Those agencies/departments included in the initial conversion were: Tax; Motor Vehicle; Health; Vermont Life; Liquor Control; Historic Sites; and Forest, Parks and Recreation. Conversion was completed on October 1, 2003.

The Court Administrator's Office has been working with the Treasurer's Office to begin accepting credit/debit cards as a pilot program. The Court Administrator has targeted implementation in three courts on March 1, 2004, and in the Judicial Bureau on April 1, 2004. The three courts selected for the pilot are the Washington District Court for all fines and fees, the Chittenden District and Family Court for all fees and services, and the Essex Superior, Family, and District Courts for all fines, fees, and services. Assessment of the feasibility of this program as well as enhancement for more effective use of the internet will be ongoing with the pilot program. The implementation in the Judicial Bureau is phased to permit revisions to the traffic citation document and modifications to the computer programs.

Credit Card Payments

Department	YTD Net Sales	YTD Fees
VT Dept. of Liquor Control	$2,144,812.32	$42,383.77
VT Dept. of Motor Vehicles	$59,103.02	$3,338.33
VT Dept. of Taxes	$800,405.22	$15,550.07
VT Dept. of Fish & Wildlife	$0.00	$5.00
VT Dept. of Health	$0.00	$5.00
Vermont Life Magazine	$247,418.69	$4,438.47
Total	$3,251,739.25	$65,720.64

State Treasurer's Office

Boards and Committees

In addition to the retirement system boards, the State Treasurer is a member of several boards and committees, established by statute, that serve an investment, fiduciary, or financial advisory role to the State of Vermont, its agencies and authorities. The Treasurer also serves in an *ex-officio* role on several important boards serving Vermonters. The following are brief descriptions of those boards or committees and their membership.

The Vermont Student Assistance Corporation (VSAC) is a public, nonprofit corporation created by the Vermont Legislature in 1965 to provide Vermonters with the information and financing they need to pursue education or training beyond high school. VSAC provides career and education information and counseling, Vermont state grants, public and private scholarships, federal and alternative education loans, and the tax-advantaged Vermont Higher Education Investment Plan. VSAC also provides financial aid services for eight Vermont postsecondary institutions. The organization employs about 350 people and is governed by board of directors.

VSAC OVER 35 YEARS OF SERVICE

VSAC Board of Directors

Chris A. Robbins, Chair
Rep. Martha P. Heath, Vice Chair
Jon F. Ratti, Secretary
Pamela A. Chisholm
Dorothy R. Mitchell
Sen. Ann E. Cummings
State Treasurer Jeb Spaulding

The Vermont Economic Development Authority (VEDA), Vermont's statewide economic development lender, is a quasi-public instrumentality of the State created by statute in 1974 to promote economic prosperity and increase employment through the operation of a variety of financing programs. VEDA offers direct loans, industrial revenue bonds, and loan guarantees, as well as a variety of additional financing programs, including agricultural loans. VEDA is governed by a 12-member Board of Directors made up of nine Vermont residents appointed by the Governor, plus the State Treasurer, the Secretary of the Agency of Development and Community Affairs, and the Commissioner of Agriculture.

VEDA works closely with the State of Vermont Department of Economic Development and the state's Regional Development Corporations to assist companies wishing to expand or relocate their businesses in Vermont.

VERMONT ECONOMIC DEVELOPMENT AUTHORITY VEDA

VEDA Members:
Susan Plausteiner, Chair
Steven Bourgeois, Vice Chair
Leon Berthuame, Treasurer
Robert Britt
David Brown
David Minot (for Jeb Spaulding)
Steven Kerr
John "Rick" Hashagen
Kenneth McEwan
Kevin Dorn
Rachel Schumacher
Henry "Sam" Chauncey
Rachel Schumacher

Boards and Committees (continued)

.VHFA Board of Commissioners

Lisa Mitiguy Randall, Chair

Gustave Seelig, Vice-Chair

Beth Pearce (*ex officio*, designee for Jeb Spaulding)

Dagyne Canney

Thomas J. Candon (*ex officio*)

John Hall (*ex officio*)

Paul J. Beaulieu

The Vermont Housing Finance Agency (VHFA**)** was established in 1974 to finance and promote affordable housing opportunities for low and moderate-income Vermonters. VHFA does not receive direct appropriation of State funds; its loan programs are funded primarily through the issuance of bonds.

The Vermont Housing Finance Agency is governed by a seven-member Board of Commissioners. The Board includes three *ex-officio* members and four members appointed by the Governor of Vermont, representing private and public lending, real estate, and housing development interests.

VMBB Board of Directors

Katherine T. Boardman, Chair
Paul M. Andrew, Jr.
David R. Coates
John Valente
State Treasurer Jeb Spaulding

The Vermont Municipal Bond Bank (VMBB) is a quasi-state agency administered by a board of directors that includes the State Treasurer and four members appointed by the Governor. The Bond Bank was established in 1970 with a mandate to provide municipalities with access to municipal bond proceeds at the lowest possible cost. To date, the Bond Bank has issued over $1.1 billion in tax-exempt new money and refunding bonds for over 750 projects and refundings. During 2003, the VMBB's long-time executive director, Malcolm Rode, retired. At that time it was decided to merge the role of executive director of the bond bank with the newly appointed Director of Finance and Investments for the State Treasury. David Minot has assumed this position. The result is an annual savings of $28,000 to the State through consolidation of similar functions.

A study released by the Fitch Rating Agency in June 2003 noted that Vermont has the best municipal bond default record of any state nationwide. Looking back to 1979, Fitch found that Vermont was the only state to have a 0% default rate.

Boards and Committees (continued)

Vermont Educational and Health Buildings Financing Agency

The Vermont Educational and Health Buildings Financing Agency (VEHBFA) is a quasi-state agency administered by a board of directors that includes the State Treasurer, seven members appointed by the Governor, two appointed by those seven members, and three additional *ex-officio* members. The VEHBFA was established in 1966 to provide non-profit educational and health care institutions the ability to borrow funds on a tax-exempt basis. To date, the VEHBFA has issued over $1.3 billion in tax-exempt bonds. Eligible borrowers include nonprofit universities, colleges, primary and secondary schools, libraries, hospitals, medical care facilities, nursing homes, and other elder-care facilities. Over the past four years, total bonds issued by the VEHBFA have ranged from a low of $38.6 million in 2001 to a high of $169.5 million in 2000. Health care facilities account for just over one-half of VEHBFA bonds issued; higher education accounted for most of the balance, and primary and secondary schools account for approximately 3%.

VEHBFA Board of Directors

Ethan A. Allen, Chair
James E. Potvin, Vice Chair
Peter A. Sherlock, Treasurer
Dawn D. Bugbee
Nancy A. Foley
Mary Pat Scarpa
Neal E. Robinson
Stuart E. Robinson
Stuart W. Wepler
Charles P. Smith (*ex officio*)
Richard Cate (*ex officio*)
Michael K. Smith (*ex officio*)
State Treasurer Jeb Spaulding

Capital Debt Affordability Advisory Committee

The Capital Debt Affordability Advisory Committee (CDAAC) completes an annual review of the size and affordability of the State tax-supported general obligation debt, and submits to the Governor and to the General Assembly an estimate of the maximum amount of new long-term general obligation debt that prudently may be authorized for the next fiscal year. The estimate of the committee is advisory, but historically has been adopted by the state as a bonding limit. The Committee is made up of four *ex officio* members and one appointee of the governor. The *ex officio* members are the state Treasurer, who serves as Chair, the Auditor of Accounts, the Secretary of Administration, and the secretary of the Vermont Municipal bond bank.

The work of the CDAAC has been very successful in reducing the State's debt burden and is recognized by the rating agencies as a significant factor in maintaining Vermont's fiscal discipline and resulting strong bond rating. This issue is discussed more extensively in the debt management section of this report.

CDAAC Committee members

Treasurer Jeb Spaulding, Chair
Elizabeth Ready, Auditor of Accounts
Michael Smith, Secretary of Administration
John Valente, Secretary of VMBB
David R. Coates, Governor's appointee

Appendices

A. Pension Fund Financial Statement for 2003

B. Annual Report on the Higher Education Trust Fund

C. Unitization Proposal

State of Vermont
Pension Trust Funds
Combining Statement of Plan Net Assets
June 30, 2003
(with comparative totals for June 30, 2002)

	Vermont State Retirement Fund	Vermont State Defined Contribution Fund	State Teachers' Retirement Fund	Single Deposit Investment Account	Vermont Municipal Employees' Retirement Fund	Vermont Municipal Employees' Defined Contribution Fund	Totals June 30, 2003	Totals June 30, 2002
ASSETS								
Cash and Short-term Investments	**$ 15,490,076**	**$ 189,460**	**$ 31,758,446**	**$ 10,862,716**	**$ 3,494,542**	**$ 66,164**	**$ 61,861,404**	**$ 53,637,233**
Receivables								
Contributions	$ 1,477,796	$ 82,330	$ 1,256,125	$	$ 1,242,862	$	**$ 4,059,113**	**$ 4,446,075**
Investments Sold	81,044,412		21,926,321	1,052,835	11,026,219		**115,049,787**	**122,864,296**
Interest and Dividends	4,244,413		4,952,335	934,855	1,061,838		**11,193,441**	**14,055,117**
Other Receivables					10,244,344		**10,244,344**	
Total Receivables	**$ 86,766,621**	**$ 82,330**	**$ 28,134,781**	**$ 1,987,690**	**$ 23,575,263**	**$ -**	**$ 140,546,685**	**$ 141,365,488**
Due from Other Funds	**$ 60,808**	$	$	$	**$ 74,028**	$	**$ 134,836**	**$ 771,832**
Investments								
Fixed Income	$ 239,751,978	$	$ 311,772,613	$ 97,085,757	$ 55,485,459	$	**$ 704,095,807**	**$ 731,260,774**
Common and Preferred Stock	550,741,642		678,291,852		43,003,156		**1,272,036,650**	**1,142,893,059**
Mortgages	13,574		1,836				**15,410**	**49,641**
Real Estate/Venture Capital	87,326,407		98,046,036		14,086,788		**199,459,231**	**227,730,145**
Mutual Funds	19,756,388	26,713,898			80,538,301	5,784,210	**132,792,797**	**111,458,362**
Total Investments	**$ 897,589,989**	**$ 26,713,898**	**$ 1,088,112,337**	**$ 97,085,757**	**$ 193,113,704**	**$ 5,784,210**	**$ 2,308,399,895**	**$ 2,213,391,981**
Prepaid Expenses	**$ 894,847**	$	$	$	$	$	**$ 894,847**	**$ 1,283,850**
Total Assets	**$ 1,000,802,341**	**$ 26,985,688**	**$ 1,148,005,564**	**$ 109,936,163**	**$ 220,257,537**	**$ 5,850,374**	**$ 2,511,837,667**	**$ 2,410,450,384**
LIABILITIES								
Accounts Payable								
Investments Purchased	$ 82,143,443	$	$ 47,465,264	$ 3,147,979	$ 22,542,736	$	**$ 155,299,422**	**$ 140,531,575**
Due to Other Funds		55,049			5,759	74,028	**134,836**	**182**
Other	874,441	9,696	1,410,364		210,314	387	**2,505,202**	**2,845,879**
Accrued Salaries Payable	17,598		20,112		4,190		**41,900**	**39,859**
Total Liabilities	**$ 83,035,482**	**$ 64,745**	**$ 48,895,740**	**$ 3,147,979**	**$ 22,762,999**	**$ 74,415**	**$ 157,981,360**	**$ 143,417,495**
Net Assets Held in Trust for Pension Benefits	**$ 917,766,859**	**$ 26,920,943**	**$ 1,099,109,824**	**$ 106,788,184**	**$ 197,494,538**	**$ 5,775,959**	**$ 2,353,856,307**	**$ 2,267,032,889**

State of Vermont
Pension Trust Funds
Combining Statement of Changes in Plan Net Assets
For the Year Ended June 30, 2003
(with comparative totals for June 30, 2002)

	Vermont State Retirement Fund	Vermont State Defined Contribution Fund	State Teachers' Retirement Fund	Single Deposit Investment Account	Vermont Municipal Employees' Retirement Fund	Vermont Municipal Employees' Defined Contribution Fund	Totals June 30, 2003	Totals June 30, 2002
ADDITIONS								
Contributions								
Employer	$ 24,394,933	$ 1,391,658	$ 20,446,282	$	$ 5,707,184	$ 440,071	$ 52,380,128	$ 50,961,100
Plan Members	12,171,186	557,333	18,820,703		5,000,479	442,375	36,992,076	35,152,814
Transfers from Other Pension Trust Funds	813,168	28,813	438,166	13,853	294,188	30,455	1,618,643	1,464,579
Other Contributions		99,082			17,561,264	4,131	17,664,477	16,276
Total Contributions	**$ 37,379,287**	**$ 2,076,886**	**$ 39,705,151**	**$ 13,853**	**$ 28,563,115**	**$ 917,032**	**$ 108,655,324**	**$ 87,594,769**
Investments								
Net Appreciation (Depreciation) in Fair Value of Investments	$ 19,007,904	$ 110,371	$ 26,284,023	$ 3,689,612	$ (540,747)	$ 117,268	$ 48,668,431	$ (177,184,737)
Dividends	9,832,017	700,940	12,567,873		1,236,336	132,328	24,469,494	23,565,733
Interest	14,294,382	2,574	17,304,661	5,732,967	2,940,435	795	40,275,814	49,999,615
Security Lendings Income	767,219		986,394		99,559		1,853,172	4,870,422
Other Income	212,076		61,381		27,237		300,694	1,073,283
Total Income from Investments	**$ 44,113,598**	**$ 813,885**	**$ 57,204,332**	**$ 9,422,579**	**$ 3,762,820**	**$ 250,391**	**$ 115,567,605**	**$ (97,675,684)**
Less Investment Expenses								
Investment Managers and Consultants	$ 3,121,258	$	$ 3,923,991	$ 304,030	$ 1,046,256	$	$ 8,395,535	$ 9,564,619
Security Lending Expenses	557,124		773,503		86,317		1,416,944	4,085,385
Total Investment Expenses	**$ 3,678,382**	**$ -**	**$ 4,697,494**	**$ 304,030**	**$ 1,132,573**	**$ -**	**$ 9,812,479**	**$ 13,650,004**
Net Investment Income	**$ 40,435,216**	**$ 813,885**	**$ 52,506,838**	**$ 9,118,549**	**$ 2,630,247**	**$ 250,391**	**$ 105,755,126**	**$ (111,325,688)**
Total Additions	**$ 77,814,503**	**$ 2,890,771**	**$ 92,211,989**	**$ 9,132,402**	**$ 31,193,362**	**$ 1,167,423**	**$ 214,410,450**	**$ (23,730,919)**
DEDUCTIONS								
Retirement Benefits	$ 41,614,187	$ 1,803,197	$ 50,409,313	$ 5,842,081	$ 4,929,747	$ 46,274	$ 104,644,799	$ 97,832,846
Refunds of Contributions	846,861		968,668		614,689		2,430,218	1,990,513
Death Claims	77,103		140,506		24,481		242,090	441,025
Transfers to Other Pension Trust Funds	369,383		702,568		546,692		1,618,643	1,464,579
Operating Expenses	10,887,792	168,642	7,398,265		118,038	78,545	18,651,282	15,536,040
Total Deductions	**$ 53,795,326**	**$ 1,971,839**	**$ 59,619,320**	**$ 5,842,081**	**$ 6,233,647**	**$ 124,819**	**$ 127,587,032**	**$ 117,265,003**
Net Increase	**$ 24,019,177**	**$ 918,932**	**$ 32,592,669**	**$ 3,290,321**	**$ 24,959,715**	**$ 1,042,604**	**$ 86,823,418**	**$ (140,995,922)**
Net Assets Held in Trust for Pension Benefits:								
Beginning of Year	**893,747,682**	**26,002,011**	**1,066,517,155**	**103,497,863**	**172,534,823**	**4,733,355**	**2,267,032,889**	**2,408,028,811**
End of Year	**$ 917,766,859**	**$ 26,920,943**	**$ 1,099,109,824**	**$ 106,788,184**	**$ 197,494,538**	**$ 5,775,959**	**$ 2,353,856,307**	**$ 2,267,032,889**

TO: Commission on Higher Education Funding

FROM: Jeb Spaulding, State Treasurer

RE: Annual Report on the Higher Education Trust Fund

DATE: September 15, 2003

I am pleased to present the State Treasurer's fourth annual report on the Higher Education Trust Fund. This fund was established in the Office of the State Treasurer by Act No. 27 of the General Assembly in 1999 and was initially funded with an appropriation of $6 million. Additional appropriations include $1 million in 2001 and $635,881.49 in 2002. The Act was amended in 2001 to provide that in August of each year, the State Treasurer shall withdraw 5% of up to a 12-quarter moving average of the fund's assets and divide the amount equally among the University of Vermont, the Vermont State Colleges, and the Vermont Student Assistance Corporation.

During fiscal year 2003, the Higher Education Trust Fund earned a total return of 7.47%. This compares most favorably with the Standard & Poor's 500 Index, which had a 0.30% return for the same period. The 5% distribution available this year is $371,794.03 in total, or $123,931.34 each for UVM, VSC, and VSAC; the distribution made following Fiscal Year 2002 was $116,225.10 for each institution. (See Appendix A for quarterly market values and distributions for fiscal year 2003.)

Act No. 27 further provides that in August of each year, the Commission on Higher Education Funding may authorize the State Treasurer to make an additional amount equal to up to 2% of the fund's assets available to UVM and the Vermont State Colleges for the purpose of creating or increasing a permanent endowment fund. The amount appropriated, however, cannot exceed an amount that would bring the fund balance below the $6 million initial appropriation plus any additional contributions to principal.

At its meeting last year, the Commission authorized this 2% appropriation in the amount of $139,470.12, or $69,735.06 each, for distribution to the University of Vermont and the Vermont State Colleges dependent upon a finding by the Commission that the terms of this appropriation have been met. Each institution was given until the end of fiscal year 2003 to match the appropriation by raising twice that amount, or $139,470.12, and to certify to the Commissioner of Finance and Management that it received private donations in the requisite amount and that the funds will be used to create or increase a permanent endowment at the respective institution. Letters regarding these certifications have been received by the Commissioner of Finance and Management.

After payments of $371,794.03 and $139,470.12, the balance in the fund at the beginning of fiscal year 2004 totals $8,061,716.86.

All principal contributions to date total $7,635,881.49 (see Chart #1 *[following]*). This represents the current minimum balance that must be maintained in the fund. The 2% distribution proposed for this year of $148,717.61 would leave a balance of $7,912,999.25 excluding any gains from investment activity in Fiscal Year 2004. If the committee authorizes this distribution, each institution's share will be $74,358.81, with a required match to be raised by each entity in Fiscal Year 2004 of $148,717.61. Chart #2 *[following]* is a graphical depiction of distributions, including the recommended 2% distribution.

An accounting of the fund balances is provided below:

Ending balance FY 2002		$7,779,947.25
FY 2002 contribution received FY 2003		635,881.49
Opening balance FY 2003		$8,415,828.74
Distribution August 2002		(477,199.05)
Income earned fiscal year 2003		464,433.91
Appreciation (Depreciation) FY 2003		199,167.07
Fees and Other Charges FY 2003		(29,249.66)
Balance June 30, 2003		$8,572,981.01
5% of 12-Quarter Moving Average June 30, 2003		$371,794.03
Distributions:	University of Vermont	($123,931.34)
	Vermont State Colleges	(123,931.34)
	Vermont Student Assistance Corporation	(123,931.34)
2% Income Available for Endowments from FY 2002		$139,470.12
Balance after distributions		$8,061,716.86
Addition to Principal		- 0 -
Opening balance FY 2004		$8,061,716.86
2% Income Available for Endowments from FY 2003 (requires institutional match FY 2004)		$148,717.61

I have attached a spreadsheet as Appendix B that shows the total return of the entire Investment Trust Account, of which the Higher Education Trust Fund at $8,572,981 (prior to cash distributions made in fiscal year 2004) comprises approximately 23%. The Tobacco Trust Fund comprises 72% of the account, or $26,843,779, and the remaining 5% is made up of eight small unexpendable trusts that total $474,585, the ANR Stewardship Fund at $493,598, and two Veterans' Home trusts totaling $865,455. Chart #3 *[Chart #12 on Annual Report page 29]* displays the relative share of the Higher Education Trust Fund compared to the entire fund. Chart #4 *[Chart #13 on Annual Report page 29]* identifies the major asset classes in the portfolio and their performance over the past three years.

As noted in Chart 3 *[following]*, assets continue to grow despite a reduction in contributions during a temporary downturn in the economy. While fixed income has been the main source of total return over the past two years, current market conditions favor rebalancing the fund to modestly increase the equity allocation. The asset allocation of the fund will be adjusted accordingly to reflect these market conditions within an overall asset risk allocation plan that takes into consideration the beneficiaries' long-term investment objectives and the distribution needs of current income.

Please feel free to contact me if you have any questions or concerns regarding this report.

cc: Robert Hofmann, Commissioner of Finance & Management
Anne Winchester, Legislative Council

Appendix A
Quarterly Market Values

	Balance 9/30	Balance 12/31	Balance 3/31	Balance 6/30	
Education Trust					
FY2001	$6,151,054.75	$6,355,860.72	$6,567,477.88	$6,679,449.36	
FY2002	$7,419,326.45	$7,661,387.97	$7,769,954.55	$7,779,947.25	
FY2003	$7,885,377.45	$8,175,418.30	$8,212,332.41	$8,572,981.01	
Twelve Quarter Average	**$7,435,880.68**				
5% Distribution 2003	**$371,794.03**				
VSAC		$123,931.34			
UVM		$123,931.34		**Contributions:**	
VSC		$123,931.34			
				Initial	$6,000,000.00
2% FY2002	**$139,470.12**			2001	$1,000,000.00
UVM		$69,735.06		2002	$635,881.49
VSC		$69,735.06		2003	$0.00
Balance after Distributions	**$8,061,716.86**			Total	**$7,635,881.49**
2% FY2003	$148,717.61				
UVM		$74,358.81			
VSC		$74,358.81			

Appendix B
Trust Investment Account
Total Return Analysis

MANAGER	**Calendar Year 2001**	Quarter ended 3/31/02	Quarter ended 6/30/02	**Fiscal Year 2002**	Quarter ended 9/30/02	Quarter ended 12/31/02	**Calendar Year 2002**	Quarter ended 3/31/03	Quarter ended 6/30/03	**Fiscal Year 2003**	Portfolio Market 6/30/03	Portfolio Percent 6/30/03
DOMESTIC EQUITY												
Hanson Investment Management	**12.41**	6.30	(6.00)	**(6.23)**	(23.55)	14.01	**(12.90)**	(4.24)	17.55	**(1.89)**	$4,192,137	11.3%
Prentiss Smith & Co.	**13.69**	1.28	(7.32)	**3.51**	(7.85)	6.76	**(7.65)**	(1.25)	10.33	**7.19**	$4,595,742	12.3%
S&P 500	***(11.87)***	*0.28*	*(13.40)*	***(17.98)***	*(17.30)*	*8.44*	***(22.12)***	*(3.15)*		***0.30***		
DOMESTIC FIXED INCOME												
NL Capital Management	**10.07**	0.44	3.35	**9.41**	3.07	2.33	**9.52**	1.30	1.94	**8.90**	$28,462,519	76.4%
Lehman Aggregate	***8.42***	*0.09*	*3.70*	***8.64***	*4.58*	*1.57*	***10.25***	*1.39*	*2.50*	***10.40***		
TOTAL FUND DOLLAR WEIGHTED RETURN	**10.50**	1.21	1.28	**7.07**	(0.09)	3.98	**6.49**	0.43	4.74	**7.47**		
Total Fund Target	**3.90**	0.13	0.16	**3.12**	0.44	3.01	**3.76**	0.43	5.54	**8.02**		
TOTAL FUND MARKET VALUE	**$32.6**	$33.3	$33.3	**$33.3**	$33.2	$34.9	**$34.9**	$35.5	$37.3	**$37.3**	**$37,250,398**	**100.0%**

Chart #1
Higher Education Trust Fund
Fund Contributions

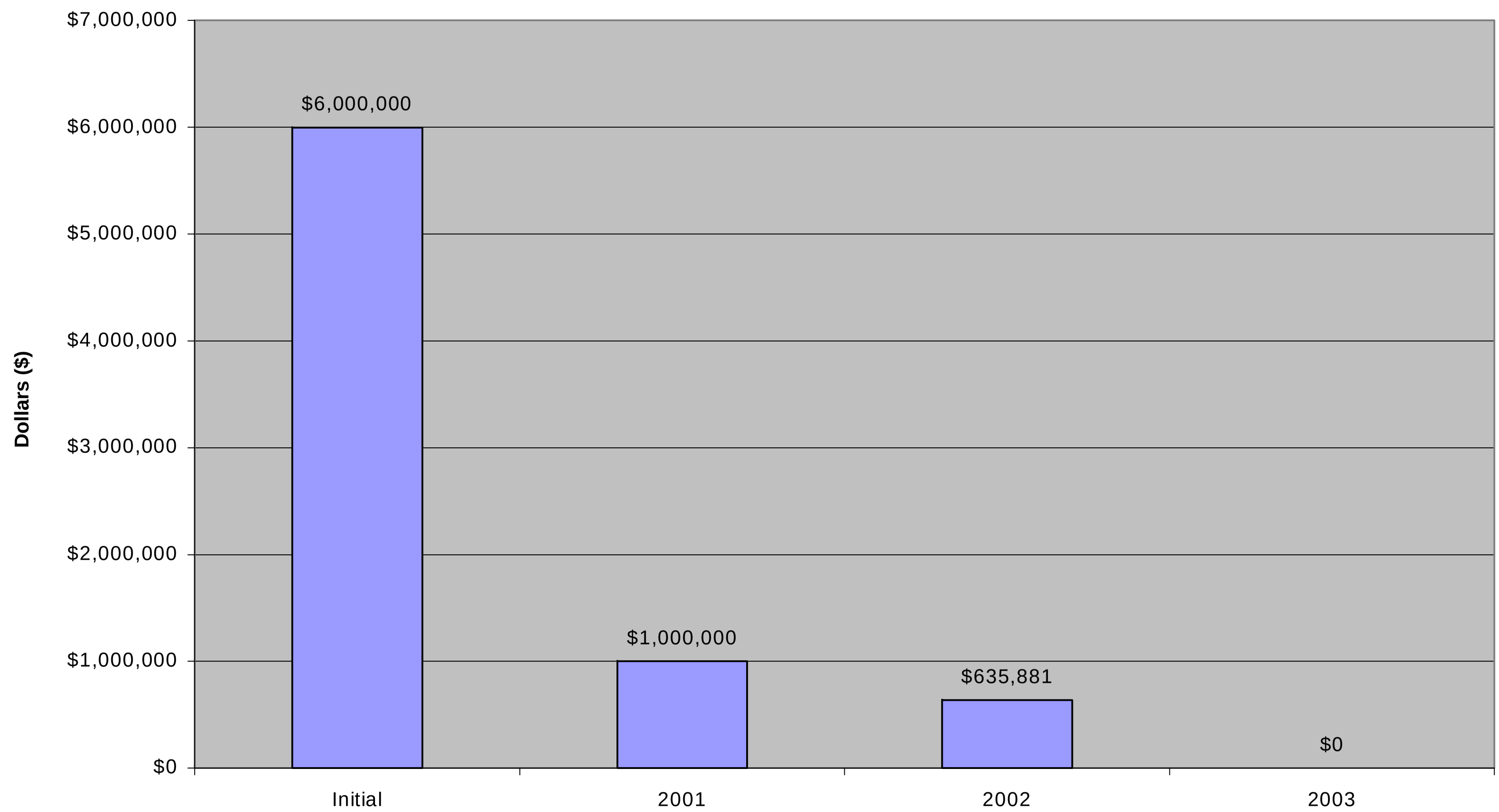


Chart #2

Higher Education Trust Fund
Distributions by Year and Type

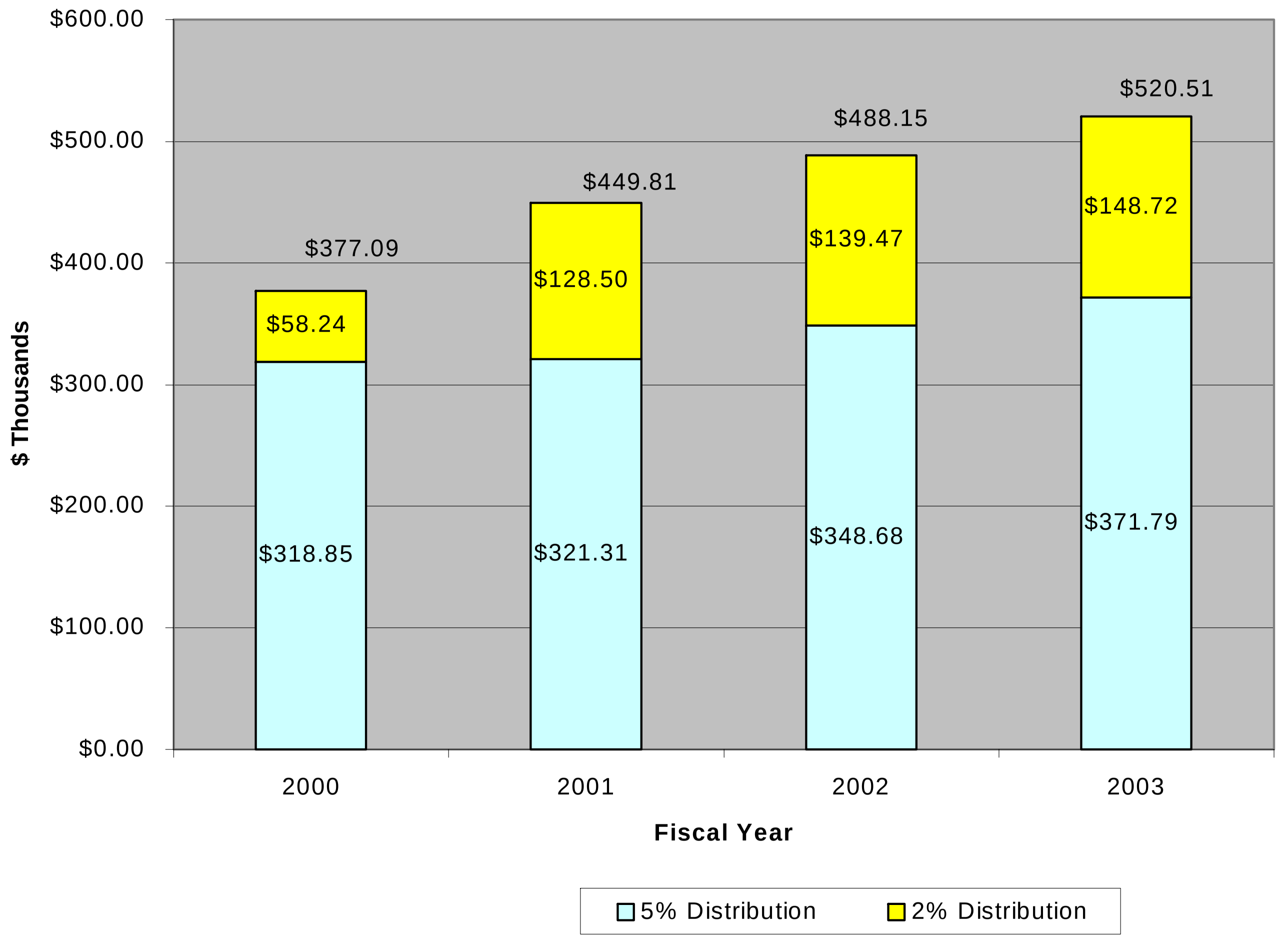
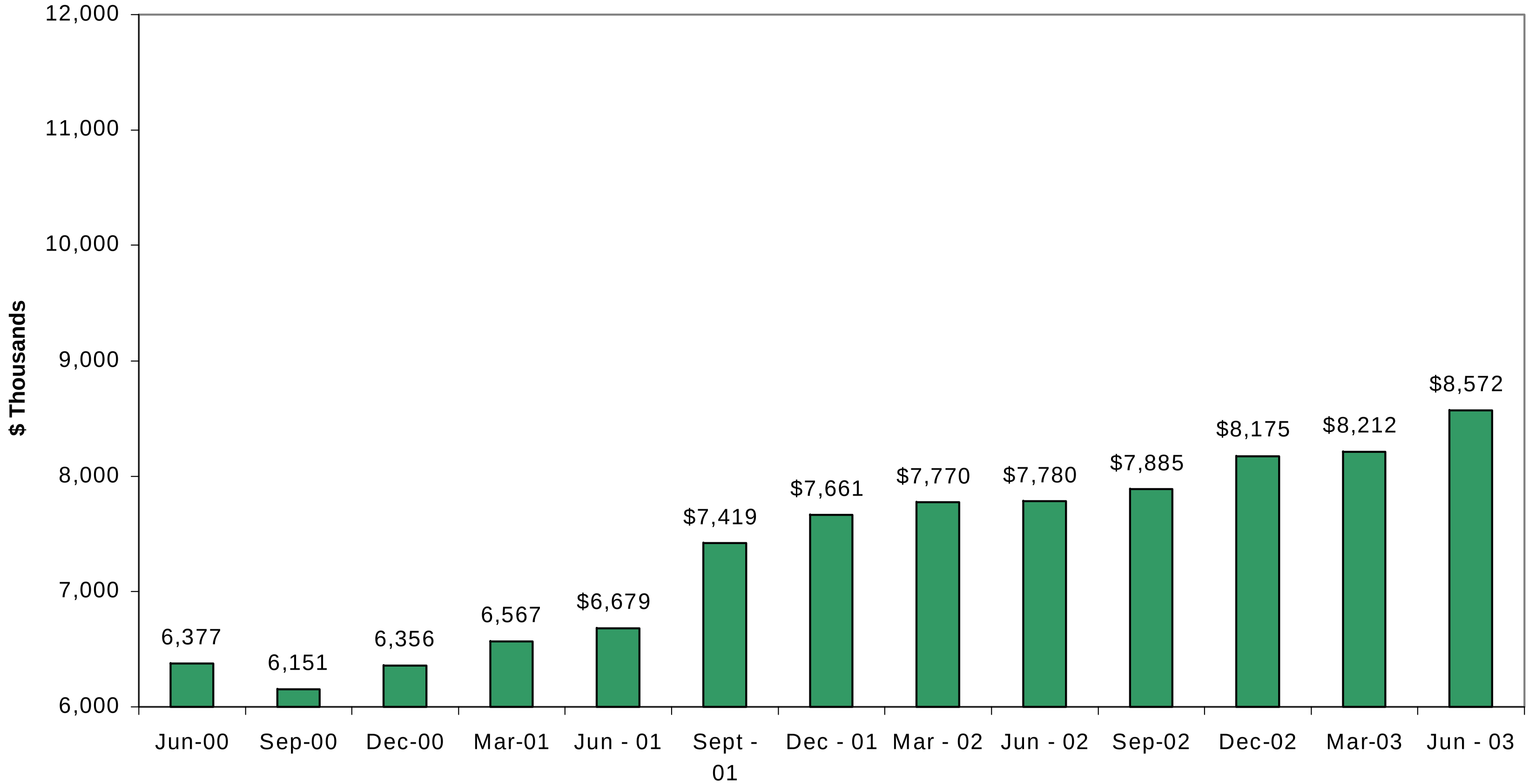


Chart #3
Higher Education Trust Fund
Asset Growth, 6/30/2000 to 6/30/2003



Proposal to

UNITIZE THE ASSETS FOR PURPOSES OF INVESTMENT OF THE VERMONT STATE TEACHERS' RETIREMENT SYSTEM VERMONT STATE EMPLOYEES' RETIREMENT SYSTEM VERMONT MUNICIPAL EMPLOYEES' RETIREMENT SYSTEM

12/10/03

Purpose

- To invest the assets of the Vermont State Teachers' Retirement System (VSTRS), the Vermont State Employees' Retirement System (VSERS) and the Vermont Municipal Employees' Retirement System (VMERS) in a manner that is more cost and resource efficient than under current practice and that improves the oversight and management of the three systems' assets.

- To maintain the actuarial, accounting and asset allocation integrity of each System.

- To respond to Act 66, Section 40 (a), of 2003: *The state treasurer, in consultation with the retirement boards referenced in 3 V.S.A. § 471, 16 V.S. A. § 1942 and 24 V.S.A. § 5062, shall develop a proposal to unitize the assets of the pension funds for the Vermont employees' retirement system, the state teachers' retirement system of Vermont, and the municipal employees' retirement system of Vermont. The proposal should include an estimate of projected cost savings and a plan for administration and governance of the unitized fund, as well as a schedule for implementation of the proposal. The proposal shall be submitted to the house and senate committees on appropriations and government operations by January 15, 2004.*

Objectives

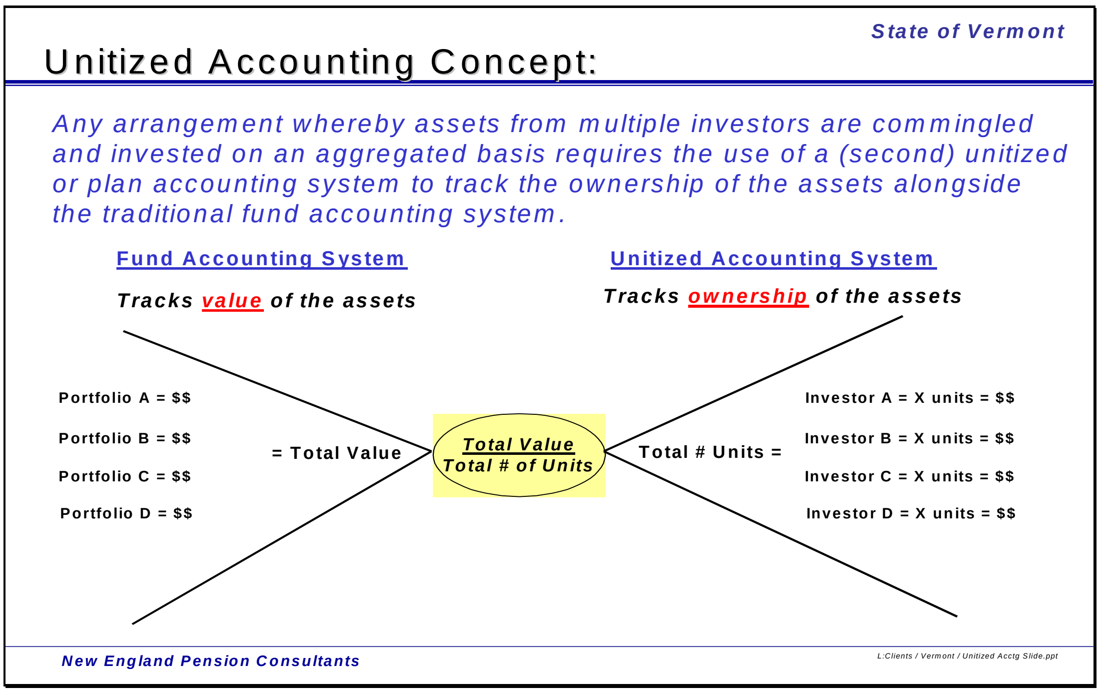
- To reduce management, advisory and custodial fees by combining investments in common asset classes (e.g., Large Capitalization Value, Global Fixed Income). Estimated savings are in excess of $900,000 per year.

- To improve the effectiveness of the Systems' investment decision and oversight processes by focusing staff, advisory and board resources through an appropriately sized and balanced joint Vermont Pension Investment Committee.

Unitization of Assets Defined

Unitization is a form of investment accounting that allows one pension fund's assets to be pooled with the assets from other pension funds for investment purposes, while maintaining its own separate identity for actuarial, accounting and asset allocation purposes. Each pension fund in a unitized system essentially owns shares in a pool. Investment growth and income are allocated to the individual funds based on the number of shares owned.

The pension funds will not be combined into a one-size-fits-all structure. Rather, each asset class will be a separate investment sleeve and each system will be able to invest in a particular sleeve, depending upon the system's unique asset allocation.



Estimated Cost Savings

While each system will retain its unique asset allocation, significant savings will be achieved through increased efficiencies and economies of scale.

Since investment manager fees are based on a tiered fee schedule, with the size of the portfolio under management ultimately determining the average (%) fee paid for each account, by consolidating assets in principal asset classes, management fees will be reduced considerably by this proposal. For example, at present there are five separate large cap managers for the three pension funds: Fidelity, Baring, Alliance, Delaware and SSGA. These five managers collectively manage eight individual equity portfolios, which under a unitized system could be combined into three to four portfolios held in one unitized large cap equity sleeve. This same process can be applied to small cap, international, fixed income, real estate and alternative asset classes.

Immediate cost savings will be achieved at State Street, our custodian bank, because the total number of individual accounts and portfolio transactions will be decreased. In addition, some commingled funds will be able to be eliminated, allowing for greater securities lending exposure and additional revenue. Additional savings will come from the investment consultant, NEPC.

Staff and administrative expenses in the Vermont Treasurer's Office will be reduced and available for reallocation with the creation of the Vermont Pension Investment Committee. At present, in addition to administering an unusually large number of contracts for pension assets the size of Vermont's, several staff members of the Treasurer's Office prepare for, attend and support quarterly investment meetings for each of the three boards.

NEPC has estimated savings, not including savings in the Office of the Treasurer, to be in excess of $900,000 per year. The following chart details an example of how the fee savings could be realized given the tiered fee schedule:

State of Vermont

Example: Consolidate Two Large Growth Accounts

- Baring – Large Growth: Employees

  Separate
  - First $30 m – 0.625% ($187.5k)
  - Next $20 m – 0.40% ($80k)
  - Over $50 m – 0.25%

  Annual Fee

  Employees - $91.4 m = $371,000

- Fidelity – Large Growth: Teachers

  Separate
  - First $25 m – 0.80% ($200k)
  - Next $25 m – 0.60% ($150k)
  - Next $50 m – 0.40% ($200k)
  - Next $100 m – 0.30%

  Annual Fee

  Teachers - $145.6 m = $686,800

Combined into 1 account* - $237 m = $735,000

Savings = $322,800 (without renegotiating fees)

** Assuming Baring's existing fee schedule*

L:Clients / Vermont / UnitizedAcctgDiscussion Slides July08.ppt

Unitized Investments Schedule

Initially, the following investment categories are expected to be available for allocation of investment funds by each retirement system; other categories may be added as needed (each system will not necessarily use all of these investment categories):

Equities

Large Cap Value
Large Cap Core/Index
Large Cap Growth

Small/Mid Cap Value
Small/Mid Cap Growth

International Large Cap Value
International Large Cap Growth

Fixed Income

Core Domestic
International

High Yield
Global

Real Estate

(2-3 R.E. managers)

Alternatives

Venture Capital
Other Direct Investments/Funds

Administration and Governance

The three existing retirement boards will continue to oversee the operations of each system in such areas as actuarial valuation, medical disability, benefit revisions, State contribution levels and general administration, as specified in Vermont Statutes.

In addition, statutes will be amended to provide for a new joint investment committee, Vermont Pension Investment Committee (VPIC), to oversee and administer the investment assets of each of the three Vermont Retirement Systems.

The capacity for effective investment oversight and administration will be significantly enhanced by this proposal. Given the small size of the individual funds, it is difficult to justify the expenditures necessary to provide the optimal level of investment education and support to three boards. Over time, the VPIC can be expected to gain an improved capability that is likely to improve the investment performance for all three funds.

The relationship between the existing boards and the new VPIC has been carefully considered. Actuarial valuation will remain the responsibility of the individual pension system boards. Subsequent to actuarial valuation and liability studies being completed and approved by system boards, VPIC will then have the responsibility of maintaining investment asset allocation for each system and investment of funds. Prior to final approval or subsequent revision by VPIC of investment asset allocation for a particular system, a report shall be delivered to the pension system board explaining the asset allocation recommendation. That board, within 30 days, shall have the power to approve or reject the proposed asset allocation, but shall not have the power to make revisions. If no response is made within 30 days, the asset allocation proposal shall be deemed approved. The VPIC would then be responsible for implementing the new asset allocation, including the selection of outside investment managers when necessary. The existing asset allocation in place at the time of the creation of the VPIC shall remain in place until approval or revision pursuant to the above process.

The primary objective of the VPIC will be maximization of investment returns within acceptable levels of risk through a broadly diversified investment portfolio. Specific responsibilities will include:

- Asset allocation, subject to the approval process referenced above
- Selection and oversight of a pension consultant and custodian bank
- Selection and oversight of investment managers
- Establishment of appropriate investment policies and guidelines
- Maintaining high levels of investment knowledge through educational offerings
- Communication with the Treasurer's office regarding all matters relating to investment of the systems' assets.

Composition of Vermont Pension Investment Committee

The Vermont Pension Investment Committee (VPIC) will be comprised of nine members, as follows:

2 – VSEA or VRSEA members from the VSERS Board
2 – Teacher, active or retired, members from the VSTRS Board
1 - VMERS Board Member
1 – Governor or Designee
1 - Gubernatorial appointee with investment experience
1 – Treasurer or Designee
1 - Treasurer appointee with investment experience
9 - Total

The VSEA and VRSEA members of the VSERS Board shall elect two members and one alternate to the VPIC. The active and retired teacher members of the VSTRS boards shall elect two members and one alternate to the VPIC. The employee and employer members of the VMERS Board shall elect one member and one alternate member of the Board to the VPIC. Members of the VPIC shall serve at the pleasure of the appointing authority and shall annually elect a Chair and Vice Chair.

Implementation Plan & Schedule

March 2004 – Bill passes and is signed by Governor
June 2004 – New board members appointed
June 2004 – Managers and custodians notified of new investment process
July 2004 - Initial meeting of the VPIC – discussion of implementation issues
Aug. / Sept. 2004 – Interview all existing managers by asset class
Oct. 2004 – Meeting with custodian to discuss reporting issues

a) Report format
b) Sleeve structure
c) Accrual of management fees and expenses

Nov. 2004 – Meeting to review final proposed manager structure and discuss transition
December 31, 2004 – Unitized accounting system initiated
Jan. / Feb. 2005 – Manager transitions conducted

After three years of implementation, a thorough evaluation of the unitized investment system will be conducted by an independent entity to document realized savings and effectiveness of the VPIC, or lack thereof. The evaluation will be delivered to the relevant legislative committees and all retirement boards.

Unitization Q&As

Will there still be a need for Individual Retirement Boards?

Yes, the existing boards will still have important roles. Examples of the kinds of responsibilities they will maintain include:

- Engagement of the actuarial consultant and approval of all actuarial studies and reports
- Periodic review of benefit and contribution levels for members of the system
- Review and approval of budget requests to Legislature, including funding adequate to cover benefit payouts
- Oversight of the provision of services and dissemination of information to members
- Investigation and voting on all disability retirement allowances
- Initiation of statutory and regulatory changes deemed necessary for the fair and effective functioning of each system
- All matters of a non-investment nature including, but not limited to, hearings of petitions from System members.

What will be the major responsibilities of the Vermont Pension Investment Committee?

- Maximization of investment returns within acceptable levels of risk though broadly diversified investment portfolios
- Allocation of assets, subject to approval by the relevant retirement board

- Selection and oversight of pension consultant and custodian bank
- Selection and oversight of investment managers
- Establishment of appropriate investment policies and guidelines
- Communication with the Treasurer's office regarding all matters relating to investment of Systems' assets.

Realizing that the performances of the three systems have been different in the past, should we feel comfortable combining investment decisions into one investment committee?

The investment performances of the three systems have been slightly different, but keep in mind that results (relative performances) depend on the time period examined.

Because each retirement system has its own asset allocation, based on actuarially derived target rates of return, much of the small investment variance is caused by differing asset class weights.

A well-balanced investment committee with adequate staff and consulting support should be able to improve the performance of all three funds, while reducing management fees.

Will a smaller number of managers be detrimental in terms of diversification and risk management?

Diversification is not normally thought of as a function of multiple managers. Barron's Dictionary of Finance and Investment terms defines diversification as, "spreading of risk by putting assets in several categories of investments – stocks, bonds, money market instruments, and precious metals, for instance, or several industries, or a mutual funds, with its broad range of stocks in one portfolio." By focusing on asset allocation and choosing the best managers for each asset class, there is every reason to believe that the return available per unit of risk will be excellent for all three systems.

Will the members of each system be losing control of investment decisions with the creation of VPIC?

While it is true that, in raw numbers, there will be fewer teachers, state employees, or municipal employees on the VPIC than the current three boards, this proposal may actually increase the board weighting of employee members to a majority status -- five employee members and four non-employee members. Currently, the VERS Board has four employee members and four non-employee members. The VSTRS has three teacher members and three non-teacher members. The VMERS Board has two employee members and three non-employee members. So, assuming the employee and employer members of the VMERS Board elect an employee member to the VPIC, employee board members, as a group, will have more say over investments on VPIC than under the current board structures.

Pension Investment Committee Structures in Other States

No other state in New England has a pension investment system similar to Vermont's current system. The VPIC proposal will move Vermont more into line with these states, which all have unified boards or committees to manage pension funds for multiple systems, except in Connecticut, where the Treasurer serves as the fiduciary/trustee for the funds with advice from an investment advisory council.

Connecticut

The State retirement system includes six retirement plans for teachers, state employees, and participating municipalities.

While there are separate retirement boards for the different groups, with some 12 to 14 members, they do not handle the investments. The State Treasurer is the principal fiduciary for the system and is responsible for the management of the pension funds. The state employees' retirement system and board are housed in the State comptroller's office. The state teachers' retirement board is a separate administrative division of the State.

There is one statutorily created 12-member Investment Advisory Council to *advise* the Treasurer regarding investments.

Twelve members –

State Treasurer
Secretary of the Office of Policy and Management
Three representatives of the teachers' unions
Two representatives of the state employees' unions
Five gubernatorial appointments with experience in investments

Maine

The Maine State Retirement System is an independent instrumentality of the State and administers retirement plans that cover State employees, public school teachers (including school administrators and other licensed/certified staff), employees of municipalities and other public entities called participating local districts (PLDs), legislators, and judges.

The responsibility for the Maine State Retirement System is vested in the eight-member MSRS Board of Trustees, all of whom are supposed to have a working knowledge of retirement issues and policy, as well as a general knowledge of finance and investments.

Eight members –

State Treasurer
One member elected by the Maine State Employees' Association
One member elected by the Maine Education Association
One system member proposed by Maine Municipal Association
Four gubernatorial appointments:
One from list submitted by Maine Retired Teachers' Association
One MSRS retiree submitted by state and/or municipal retirees
Two experts in investments, accounting, banking on actuarial science

Massachusetts

The Pension Reserves Investment Trust ("PRIT") Fund is a pooled investment fund established to invest the assets of the Massachusetts State Teachers' and Employees' Retirement Systems, and the assets of county, authority, district, and municipal retirement systems that choose to invest in the Fund. There are separate boards charged with administering the system for teachers, state employees, and municipal employees.

The nine-member PRIM Board acts as Trustee for all retirement system investments in the PRIT Fund and is responsible for the control and management of the Fund. There is also a six-member investment advisory committee to the PRIM Board, created by the PRIM Board.

PRIM Board - Nine Members–

State Treasurer, Chair
Governor, or designee
One of the elected members of the State Teachers' Retirement Board
One of the elected members of the State Employees' Retirement Board
One elected by the retirees of the State Teachers' Retirement System
One elected by the retirees of the State Employees' Retirement System
Two Gubernatorial appointments
One Treasurer appointment

Investment Advisory Committee – Six members – Appointed by PRIM Board

David Grain, Treasurer's appointment, is Chair – experienced in investments/finance
Doug Rubin, First Deputy Treasurer
Glenn Strehle, Treasurer Emeritus, MIT
Herman Daley, Deutsche Asset Management
Peter Brooke, Private Equity Investment Professional
Ralph White, Board member (state employee member)

New Hampshire

The New Hampshire Retirement System is an independent instrumentality of the State and includes 47,000 active and 16,000 retired State employees, teachers, and police/firefighters.

The responsibility administration of the system and management funds is vested with a 13-member Board of Trustees.

Thirteen Members –
Treasurer
Two gubernatorial appointments – not members of system/business experience
Two state employees, nominated by NHSEA and appointed by Governor
Two teachers, nominated by NHEA and appointed by Governor
Two policemen, nominated by police association and appointed by Governor
Two firefighters, nominated by firefighters' association and appointed by Governor
One State Senator
One Representative

Rhode Island

The Employees' Retirement System of Rhode Island serves state employees and teachers, as well as cities and towns that choose to participate, and is administered through the State Treasurer's Office.

There is both a Retirement Board and a State Investment Commission.

ERS Retirement Board – 15 members
- Treasurer
- Director of Administration
- Budget Officer
- Fiscal Advisor to House Finance Committee
- President of League of Cities and Towns
- Two active state employees or union officials elected by active state employees
- Two active teachers or union officials elected by active teachers
- One active municipal employee or union official elected by active employees
- One retired member of ERS elected by retired members of the system
- Chair of House Finance Committee
- Chair of Senate Finance Committee
- Two gubernatorial appointments, one of whom is a C.L.U.

State Investment Commission - Nine voting members/one non-voting member
- Treasurer
- Director of Administration
- Chair of Senate Finance Committee

Chair of House Finance Committee
Chair of the Higher Education Assistance Authority
One teacher, state employee, or municipal employee appointed by the Treasurer
Executive Director of the State Retirement Board (nonvoting member)
Three members appointed by Governor, experienced in investments/finance

In addition to the New England States, the investment governance systems of Michigan and Pennsylvania were examined.

Michigan

Michigan operates separate systems for state employees and teachers, as well as a separate system for State police, judges, and legislators. The Michigan Municipal Employees' Retirement System is an independently operated entity. They are all housed administratively within the Department of Management and Budget, Office of Retirement Services.

The State Employees' System has two plans, a defined benefit plan and a defined contribution plan. According to their Web site, State employees hired on or after March 31, 1997, are enrolled in the defined contribution plan.

The net asset value of the defined benefit plan was $8.4 billion as of 9/30/02.

The State Employees' Retirement System Board is the investment authority for the fund and has nine members:

The Insurance Commissioner
The Attorney General
The State Treasurer
The Deputy Legislative Auditor General
The State Personnel Director
Two employee members, appointed by the Governor
Two retired system members, appointed by the Governor

The Public School Employees' Retirement System as an eleven-member board, but the State Treasurer is the investment authority for the pension fund, which had a market value of $29.9 billion as of 9/30/02.

There is a statutorily created five-member "Investment Advisory Committee" to the State Treasurer, which has limited powers to require certain actions by the Treasurer:

Three public members appointed by the Governor with senate confirmation
The Director of Consumer and Industry Services
The Director of Management and Budget

The Michigan Municipal Employees' Retirement System is an independent public nonprofit organization, which is an instrumentality of MERS participating municipalities.

The system had approximately $3.5 billion in investment assets as of June 30, 2002. The investment authority and responsibility is vested in a nine-member board:

Three officer members
Three employee members
One Retiree member
Two public members

Pennsylvania

Pennsylvania maintains separately administered state systems for teachers, state employees, and municipal employees.

The State Employees' Retirement System administers both a defined benefit and defined contribution system, with total fund assets of approximately $21 billion in 2002.

Investment authority is vested in an eleven-member board:

Six members appointed by the Governor
Two state representatives
Two state senators
State Treasurer (elected Chair)

The PA Public School Employees' Retirement System has pension fund assets of approximately $42 billion, as of 6/30/03.

Investment authority and responsibility is vested in a 15-member board:

Secretary of Education
State Treasurer (elected Chair)
Executive Director of PA School Boards' Association
Two members appointed by the Governor
One member of the Annuitant Group elected among their number
Three members elected from among the certified contributors
One member elected from among non-certified contributors
One member elected by members of the PA school boards
Two State representatives
Two State Senators

The Pennsylvania Municipal Retirement System had assets of $887 million as of March 30, 2003.

Investment Authority and responsibility is vested in an eleven-member board. The State Treasurer and the Secretary of the Commonwealth serve on the Board by virtue of their position. Another eight board members are appointed by the Governor after being nominated by their respective organizations or associations (municipalities, police, firefighters, etc.). In addition, one board position is filled by a retired member of the Pennsylvania Municipal Retirement System, whom the Governor appoints from a pool of interested applicants.