2006 Annual Report

Issued January 2007

State of Vermont
Office of the State Treasurer
109 State Street
Montpelier, Vermont
www.vermonttreasurer.gov

Jeb Spaulding
State Treasurer

Photo taken from summit of Mt. Mansfield by D. Pruden.

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Appendices

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

It is my pleasure to present to you the 2006 Annual Report for the Office of the State Treasurer. This was a year of many significant accomplishments for our office. I would like to sincerely thank all of the dedicated and hard-working members of the “treasury team” for their support and commitment to serving Vermonters. I hope you find this report to be an informative look at the Treasurer’s Office – the services we provide, our accomplishments, and the various reporting requirements of our office.

The Office of the State Treasurer performs a wide variety of functions. In many ways, we serve as the State’s banker. We manage over $4 billion in operating cash; plan and implement a long-term capital financing strategy; provide guidance to other agencies on appropriate uses of bonded funds; administer the state’s unclaimed property act; and administer three major pension plans, the deferred compensation plan, and the defined contribution plan. The Treasurer serves on the boards of all three retirement systems (for state employees, teachers, and participating municipalities), is the current chair of the Vermont Pension Investment Committee, and also serves by state statute on boards for several entities, such as the Vermont Economic Development Authority, the Vermont Student Assistance Corporation, and the Vermont Housing Finance Authority.

The Office of the State Treasurer remains committed to maintaining prudent and disciplined fiscal practices, while at the same time demonstrating leadership and innovation on many important financial issues facing our fellow citizens: ensuring adequate, sustainable, and actuarially sound retirement benefit plans for our public employees; increasing retirement savings by all Vermonters; financing critical infrastructure; and implementing investment strategies that support community and economic development in Vermont.

Many of the accomplishments discussed in this report result from collaboration with various state agencies and departments, the Governor’s Office, and the Legislature. We can all be proud of these mutual efforts to provide quality services to Vermonters in a cost-effective manner.

There is one subject that I feel compelled to emphasize in some detail in this transmittal letter: the subject of funding the retirement plans for state employees and teachers.

Consistent with my fiduciary responsibility as a trustee and custodian for the State's three pension funds for state employees, teachers, and municipal employees, I encourage proactive adoption of practices to protect the long-term viability of the retirement plans for the benefit of current and future retirees, as well as to protect the interests of all Vermont taxpayers. In recent years, I have repeatedly expressed concern relative to retirement plan funding in Vermont, especially as it relates to the Vermont State Teachers' Retirement System. While the state employees' and municipal employees' systems are comparatively healthy, a significant unfunded liability remains for the Vermont State Teachers' Retirement System.

That stated, one of the most significant accomplishments of the last General Assembly was the adoption of all of the major recommendations of the *2005 Commission on Funding the Vermont State Teachers' Retirement System.* These recommendations, now law, provide the foundation to get funding back on track after years of underfunding that threatened the integrity of the system and the wallets of future taxpayers.

Recommendations adopted by the Legislature and Vermont State Teachers' Retirement System Board of Trustees include:

- Adoption of the Entry Age Normal actuarial methodology, because doing so provides a more accurate picture of the plan's funded status and is consistent with most public retirement plans.
- Re-amortization of the unfunded actuarial liability (UAL) over 30 years because, while this will increase plan costs over that period, it will reduce the State's required annual contribution substantially.
- Creating separate appropriations for normal and UAL costs, because doing so will make plan costs associated with underfunding distinct from costs associated with paying benefits.
- Fully funding both normal and UAL costs beginning in FY 2007, because doing so is necessary both to justify implementing other recommendations and to preserve the fiscal integrity of the Vermont State Teachers' Retirement System.
- Increasing the assumed rate of investment return by .25% because doing so reflects the beneficial effects of Vermont's new unified pension fund investment process.

Thankfully, for the first time in many years, the 2006 Legislature appropriated the full actuarial recommendation for the Vermont State Teachers' Retirement System. In order to make the implementation of those recommendations useful over time, the State will need to faithfully appropriate the actuarially required amount each year going forward. It remains our common task now to ensure that the state meets its funding obligation each year from now on.

The 2006 General Assembly also recognized the larger issue of ensuring that retirement plans for state employees and teachers are appropriate and sustainable over the long term. Thus, they requested that my office contract with an independent expert to review, evaluate, and make recommendations on pension and retiree health plan provisions and design, as well as benefit and contribution levels, for Vermont state employees and teachers. The review was intended to support an adequate, sustainable, and actuarially sound pension and retiree health plan, consistent with governmental accounting standards as well as demographic and workforce trends.

Buck Consultants has issued a report and recommendations which I hope the Governor and Legislature will seriously consider. While there may be differing views on particular Buck recommendations, there should be no doubt that demographic and workforce trends require us to consider now whether current benefits, plan provisions, and contribution levels will be appropriate 10-20 years in the future.

Since the kind of benefit level and plan provision adjustments included in the Buck Report are often implemented only for new hires, this issue is especially timely. Governor Douglas's 2005 Strategic Enterprise Initiative pointed to "a bubble in the state workforce, when 26 percent will be retirement eligible in five years, and 43 percent in ten years." Recognizing a once-in-a-generation opportunity, the Governor's staff is considering a number of efforts to improve the efficiency and effectiveness of government operations. We also have a once-in-a-generation opportunity to review benefits for new employees before locking in current benefits, plan provisions, and contribution levels for another generation.

The Buck report and other analyses will undoubtedly point to some hard decisions to be made over the next few years. This can, however, be an opportunity to create a win-win situation – a chance to "retool" the retiree pension and health benefit structure in a manner that meets the needs of current and future retirees and is, at the same time, affordable to taxpayers and therefore sustainable.

An additional retirement-related challenge facing Vermont is compliance with recently adopted standards by the Governmental Accounting Standards Board (GASB 43 and 45) covering other non-pension post-employment benefits (OPEBs), primarily health insurance, for Vermont teachers and state employees. These new standards will have major financial and disclosure ramifications for the State of Vermont beginning in Fiscal Year 2008. For the first time, public sector entities will be expected to report the future costs of OPEBs in their financial statements. These new standards do not require pre-funding such benefits, but the basis applied by the standards for measurement of costs and liabilities for these benefits is more conservative if they are funded on a pay-as-you-go basis – as they presently are in Vermont and many other states – and not pre-funded in the same manner as traditional pension benefits, resulting in far larger yearly cost and liability accruals on a pay-as-you-go basis.

The State's independent actuary has prepared reports with initial valuations and funding estimates for the State's OPEB liabilities as of June 30, 2006. The reports present two separate calculations of the State's OPEB liability, depending on whether the liability would be pre-funded or remain on a pay-as-you-go basis.

For the Vermont State Employees' Retirement System, assuming no pre-funding, the actuarial accrued liability for OPEB obligations earned through June 30, 2006, is $552.2 million. However, if pre-funding is assumed, the actuarial accrued liability would be reduced to $303.5 million, and the annual required contribution was estimated at $25.3 million for fiscal year 2007. Because current expected benefit payments approximate $15.0 million, the initial expected increase in annual cost to pre-fund OPEBs was $10.3 million.

For the Vermont State Teachers' Retirement System, assuming no pre-funding, the actuarial accrued liability for OPEB obligations earned through June 30, 2006, is $952.5 million. However, if pre-funding is assumed, the actuarial accrued liability is reduced to $414.3 million and the annual required contribution was estimated at $35.4 million for fiscal year 2007. Because current expected benefit payments approximate $13.3 million, the initial expected increase in annual cost to pre-fund OPEBs was $22.1 million.

The recommendations included in the aforementioned Buck report would reduce OPEB liabilities significantly and should be considered as part of a comprehensive plan to address GASB 43 and 45. Any resulting annual savings from pension or OPEB revisions should be dedicated to funding for GASB 43 and 45 liabilities.

On a related topic, one of the most serious policy issues facing our state over the next several decades will be the combination of an aging of our population and the lack of adequate retirement savings by many of our citizens. We know that a large percentage of Vermonters are not currently saving for retirement and that taxpayers will bear the ultimate responsibility for seniors with insufficient savings. We also know people are more likely to save if a simple retirement plan is available at work and that by providing a simple, inexpensive, high-quality, and safe retirement plan option for small employers and self-employed Vermonters, we can increase critical savings for retirement.

Research that shows 8 of 10 of those people offered a retirement plan at work say they participate and that very few workers participate in automatic savings arrangements outside of work. Unfortunately, research also shows that 70% of firms with fewer than 25 employees offer no formal retirement plan. More than ¾ of Vermont's business establishments have nine or fewer employees. Many of Vermont's small businesses want to provide retirement plans for their workers but are unable to do so because of cost, confusion, and administrative barriers. This results in a retirement savings void for many of our citizens.

We should encourage more Vermonters to save for retirement and help more businesses create employment-based retirement savings programs for their employees. That is the purpose of a proposed Vermont Voluntary Retirement Savings Program. This proposal, made by legislative members of three political parties (Democrat, Republican, and Progressive) and the State Treasurer's Office envisions a collaborative public/private partnership to provide a simple, inexpensive, and high-quality voluntary retirement savings program to assist employers, employees, and, perhaps, self-employed Vermonters in saving for retirement at no cost to taxpayers. The program would provide for tax-deferred savings and enable employees to defer a portion of their pre-tax compensation to their retirement accounts through automatic payroll deduction. Administrative fees would be covered in the fee for plan participants.

The Vermont Voluntary Retirement Savings Program would make the process of adopting a plan easy for the small business owners by simplifying decisions and paperwork regarding a provider, plan design, and investments. They will be reassured by knowing that the plan they offer their employees will reflect a "best practices" design in terms of investment options and other plan characteristics. And they will know that the cost for the plan is very low due to the clout of State of Vermont negotiating power. The stamp of approval and marketing power of the State will likely be effective in attracting more businesses to offer retirement savings plans for their employees than now do so. The plan will be totally voluntary for all involved – employers, employees, and the self-employed. There will be no required employer match, though a match certainly would be very helpful in increasing employee participation.

The Vermont Voluntary Retirement Savings Program can be a win-win-win proposition: Vermonters will have more savings and a better quality of life at retirement, businesses will be able to attract and retain employees with enhanced benefits at little or no cost to their business or taxpayers, and state government will avoid some future liabilities for those with inadequate retirement savings. I hope this proposal will receive serious consideration in the current legislative session.

As we face the next several years, we must also be cognizant of the range of challenges Vermont faces in maintaining important, high-quality services that taxpayers can afford. There are increasing pressures upon limited resources. Success in meeting those challenges will require the same collaborative effort that has served us so well to date. I stand ready to continue our partnership in tackling the financial issues affecting all of us here in Vermont.

My staff and I are available to discuss the information in this report, and welcome your inquiries and/or comments. You will find a great deal of additional information by visiting our Web site at www.vermonttreasurer.gov .

Sincerely,

Jeb

Jeb Spaulding
State Treasurer

About the Vermont State Treasurer's Office

Responsibilities

The State Treasurer's Office is responsible for a wide range of administrative and service duties as prescribed by State statutes:

- Investment of State funds.
- Issuing of all state bonds authorized by the General Assembly.
- Serving 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 personal or financial property, which is 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, teachers, and participating municipalities.

Administration and Organization

The Treasury is organized into an executive office and six divisions. The executive office is responsible for overall strategic planning, legislative initiatives, constituent relations, debt management, and supervision of the divisions.

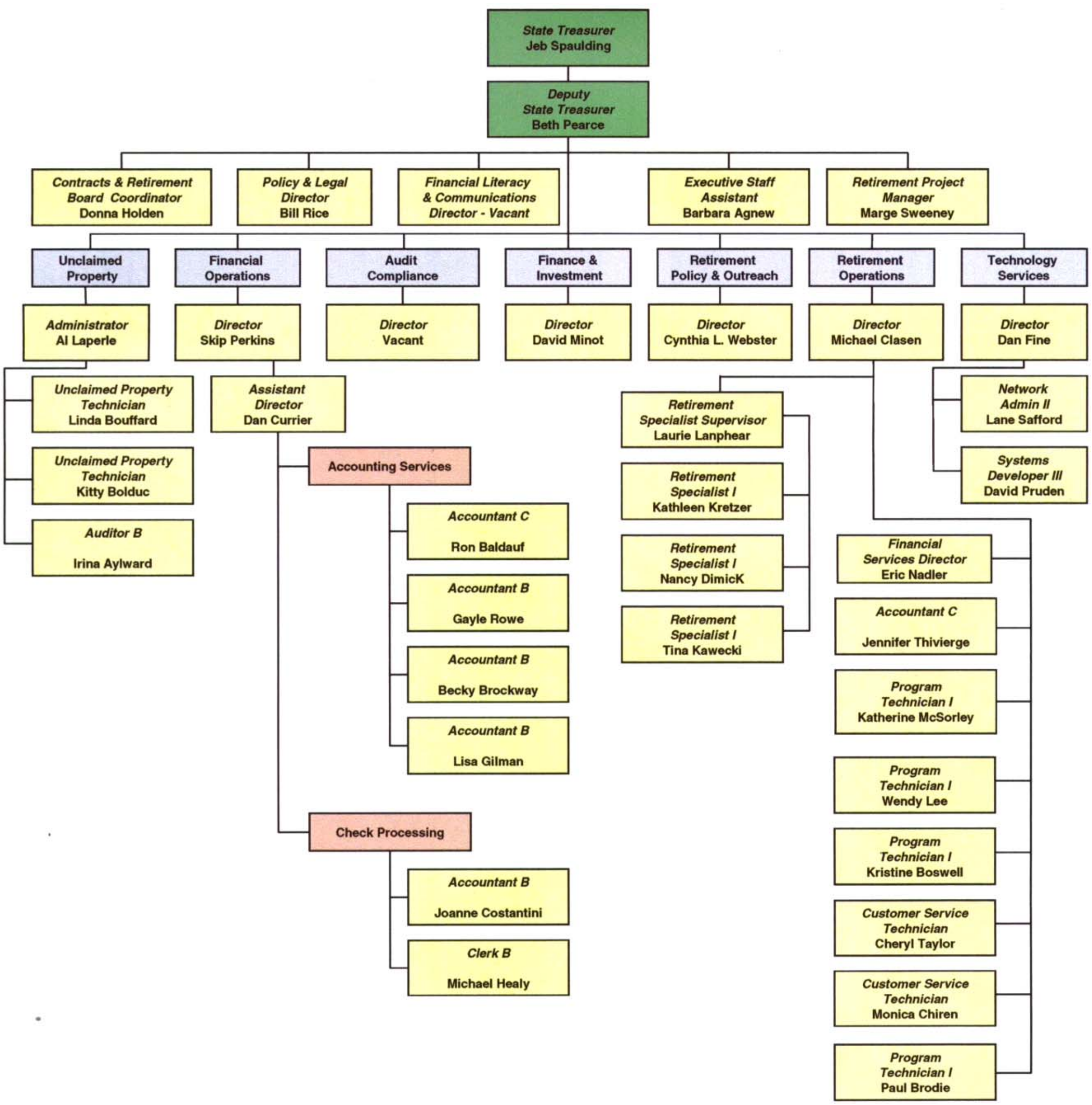
- Financial Operations is responsible for the State's banking, cash management, and financial transaction services.
- The Unclaimed Property division of the office serves as caretaker of abandoned or unclaimed property while seeking to return it to its proper owners.
- Finance and Investment Services provides cash, investment, and debt management for the State of Vermont and the three pension systems (State Employees, Teachers, and Municipal Employees) that are administered by the Treasurer's Office.
- Technology Services 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 public retirement systems authorized by the Legislature. They are for state employees, school teachers (grades K-12), and municipal employees. Over 43,000 people are covered by these retirement systems.
- The Audit Compliance Division was created in 1999 to conduct independent reviews of financial operations and controls within the State Treasurer's Office. The division ensures that acceptable policies and procedures are followed, established standards are met, and resources are used efficiently and economically.

Administration and Organization, continued

Our Commitment to Vermonters

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 investment returns in its funds within acceptable risk parameters.

Exhibit #1
Office of the State Treasurer



Administrative Office staff: Left to right, Deputy Treasurer Beth Pearce; Contracts and Retirement Board Coordinator Donna Holden; Director of Legal and Policy Research Bill Rice; State Treasurer Jeb Spaulding; Executive Assistant Barbara Agnew; and Director of Finance and Investments David Minot.

Retirement Specialist Nancy Dimick assists customers in planning their retirement.

Joanne Costantini helps a customer pick up a replacement check**.**

Barbara Agnew schedules a legislative committee appearance by the Treasurer.

Linda Bouffard and Irina Aylward process stock payments for an unclaimed property claimant.

Vermont Retirement Systems

Marie H. Duquette

Member, Vermont Pension Investment Committee

Trustee, Vermont Municipal Employees' Retirement System

Trustee, Vermont State Colleges

Member, Commission on Women

Former Director of Finance and Investments, Office of the State Treasurer

As this report went to press, we learned of the untimely death of Marie Duquette. With her extensive investment background and commitment to public service, she made a significant contribution on behalf of retirees to the success of the pension investment program. We appreciate her contributions and will miss her wise counsel and sense of humor.

Retirement System Overview

The State Treasurer's Office administers three statutorily defined benefit pension plans with 24,933 active members, 5,963 inactive members, 1,982 terminated vested members, and 10,293 retired members as of June 30, 2006. 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 those made by the State. The Vermont Municipal Employees' Retirement System is employer/ employee funded, and does not have a state contribution component.

In each case, a board of trustees is charged with the responsibility of general administration and proper operation of the retirement system. Day-to-day retirement operations are administered through the State Treasurer's Office based on policies and guidelines adopted by the boards of trustees. The State Treasurer is a member *ex officio* of each board.

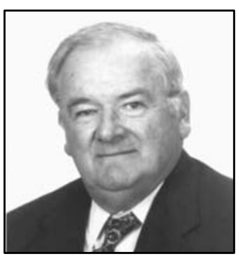
A flurry of activity has occurred this past year that affects the retirement systems and their members. The VMERS saw the addition of ten new municipal entities over the past calendar year. In addition, the VMERS board has been aggressively pursuing an option to provide a health premium reimbursement account that retirees may access to assist them with their health care needs. They hope to have a plan in place in July of 2007. Minimum pension increases were processed for over 490 retired teachers and over 230 retired state employees as a result of legislation that passed effective September 1, 2006. A new dental plan will be available to retirees of the Vermont State Retirement System in February of 2007. The expectation is that it will be expanded to retirees of the Vermont Teachers' and Municipal Employees' Retirement Systems at some point in the future. Finally, several positions within the Retirement Division were re-structured in order to provide more efficiencies and better customer services to all active and retired members.

Vermont Retirement Systems (continued)

Vermont State Employees' Retirement System Board (VSERS)

Name	Position
Warren Whitney	Chair, VSEA Representative
Robert Hooper	VSEA Representative
Tom Giffin	VSEA Representative
Joe Healy	RVSEA Representative
Jeb Spaulding	Vice Chair, State Treasurer
Linda McIntire	Commissioner of Human Resources
James Reardon	Comm. of Finance & Management
Richard Johannesen	Governor's Delegate
Michelle Black	VSEA Alternate





Top row, left to right: Warren Whitney, Bob Hooper, and Jim Reardon. Second row: Joe Healy, Linda McIntire, and Tom Giffin. Third row:: Dick Johannesen and Jeb Spaulding.

Vermont Retirement Systems (continued)

Vermont Municipal Employees' Retirement System Board (VMERS)

The board is comprised, by statute, of a representative designated by the Governor; the State Treasurer; and two municipal employees and one municipal official elected by the membership of the system. Left to right: Marie Duquette; W. John "Jack" Mitchell; Jeb Spaulding; David Lewis, Vice-Chair; Steve Jeffrey, Chair; and Executive Secretary Cynthia Webster.

Vermont State Teachers' Retirement System Board (VSTRS)

The board is comprised, by statute, of 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 members of the system elected by members of the system; and one member elected by the board of directors of the Association of Retired Teachers of Vermont.

Left to right: Vice-Chair Jon Harris; Cynthia Webster; Jeb Spaulding (standing); Chair Joe Mackey; Tom Candon (standing); Jay Kaplan; and Vaughn Altemus.

Retirement Division Operations

ACCOMPLISHMENTS IN 2006

- **PERFORMANCE INDICATORS - Staff of the Retirement Division conducted 1,050 individual counseling sessions and processed a total of 785 retirements for members of the three systems during the 2006 calendar year — 413 Teacher retirees, 273 State retirees, and 99 retirees in the Municipal system. Staff also calculated over 8,600 retirement estimates at the request of prospective retirees, a 23 percent increase over 2005. A variety of staff conducted 51 informational sessions across Vermont for members of the three systems in 2006, at which approximately 1,380 individuals were in attendance.**

- **NEW MUNICIPAL ENTITIES - This past year ten new entities joined the Municipal Employees' Retirement System.**

- **MINIMUM PENSION INCREASE - A bill passed during the 2006 legislative session increased the minimum pension for certain State retirees whose pensions were below $6,600 and for certain Teacher retirees whose pensions were below $9,000 at the time of retirement. Immediately after processing the 326 July 1st retirements, staff in the Retirement Division worked on the calculations to increase the minimum pensions for more than 490 retired teachers and 230 retired state employees. All of these retirees received the pension increase beginning with their September 2006 pension payments, as required by the new law.**

- **ACTUARIAL REVIEW - This past year the Treasurer's Office, following a competitive bidding process, selected the actuarial firm of Gabriel, Roeder, Smith and Company (GRS) to perform an actuarial review of Buck Consultants, the actuarial firm that prepares the annual valuations for the State, Teachers', and Municipal Retirement Systems. The purpose of the review was to analyze the actuarial assumptions and methods and to perform a complete replication of the actuarial reports to test each plan's valuation results. We are pleased to report that GRS found that for all three systems:**

    - **The stated liabilities for the plans match quite closely.**
    - **There were no major concerns with assumptions and methods.**
    - **The most recent experience study for each system was reasonable.**
    - **The assumptions and methods are reasonable.**
    - **Overall, reporting is fair and accurate.**

Retirement Staff

From left to right, standing: Cheryl Taylor, Cynthia Webster, Michael Clasen, Jennifer Thivierge, Kathleen Kretzer, Monica Chiren, Nancy Dimick. Seated: Tina Kawecki, Katie McSorley, Laurie Lanphear, and Wendy Lee.

Vermont Retirement Systems (continued)

The State Treasurer's Office administers three statutory defined benefit pension plans. These plans are the State Teachers' Retirement System of Vermont, the Vermont State Employees' Retirement System, and the Vermont Municipal Employees' Retirement System. Please refer to Charts #1 - #3 for comparative membership data on the three defined pension benefit plans.

In addition, the Office also administers several other retirement plans. These include two defined contribution plans that are offered as an alternative to the defined benefit plans for certain employee groups: a deferred compensation (457) program for state employees; and a single depository investment account (SDIA), a tax-sheltered account funded through employee transfers from a non-contributing system. Although Retirement contracts with third-party administrators to handle the investment options and day-to-day bookkeeping responsibilities for these plans, the office is responsible for providing new hires with information and comparisons of projected benefits, and 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 Retirement Division is currently comprised of 12 staff members. The primary function of the staff is to serve the needs of the active contributing members and retired members receiving benefits payments. On the active member side, the Retirement 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 appointments or walk-ins which are directed through the front office staff. 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 throughout the state. Program Technicians in the Employer Reporting Unit provide daily support and technical assistance to the over 700 reporting entities in the Teacher and Municipal systems. The Retirement Division's accountant maintains all retiree data and ensures the timely processing of over 10,000 pension payments each month.

A breakdown of selected performance indicators for the Retirement Division is detailed in Chart #4.

Staff also processed 1,031 purchase requests for service credit, a 25% increase over 2005, and acknowledged 104 Qualified Domestic Relations Orders, a 16% increase over 2005.

Charts #1- #3

Vermont State Employees' Retirement System			
	June 30, 2006	June 30, 2005	Percent Change
Active Members			
Vested	5,652	5,479	3.16%
Not Vested	2,636	2,589	1.82%
Total Active Members	8,288	8,068	2.73%
Average Age	46.15	45.94	0.46%
Average Service	12.09	12.15	-0.49%
Average Compensation	$ 44,560	$ 43,289	2.94%
Retired Members and Benficiaries			
Number	4,173	4,002	4.27%
Annual Retirement Allowances	$ 55,043,322	$ 51,105,010	7.71%
Inactive Members	1,111	1,104	0.63%
Terminated Vested Members	805	832	-3.25%

State Teachers' Retirement System of Vermont			
	June 30, 2006	June 30, 2005	Percent Change
Active Members			
Vested	8,020	8,084	-0.79%
Not Vested	2,676	2,660	0.60%
Total Active Members	10,696	10,744	-0.45%
Average Age	46.73	46.66	0.15%
Average Service	13.58	13.65	-0.51%
Average Compensation	$ 46,657	$ 45,311	2.97%
Retired Members and Benficiaries			
Number	4,879	4,592	6.25%
Annual Retirement Allowances	$ 66,776,433	$ 60,545,793	10.29%
Inactive Members	2,777	2,906	-4.44%
Terminated Vested Members	759	568	33.63%

Vermont Municipal Employees' Retirement System			
	June 30, 2006	June 30, 2005	Percent Change
Active Members			
Vested	3,037	2,833	7.20%
Not Vested	2,912	2,992	-2.67%
Total Active Members	5,949	5,825	2.13%
Average Age	46.77	46.50	0.58%
Average Service	6.57	6.40	2.66%
Average Compensation	$ 25,015	$ 23,727	5.43%
Retired Members and Benficiaries			
Number	1,241	1,090	13.85%
Annual Retirement Allowances	$ 6,997,737	$ 5,634,093	24.20%
Inactive Members	2,075	2,003	3.59%
Terminated Vested Members	418	363	15.15%

Vermont Retirement Systems (continued)

Chart #4

Retirement Division Performance Indicators				
Activity	Calendar 2006	Calendar 2005	Calendar 2004	Percent Change 2005 - 2006
Estimates	8,672	7,031	4,700	23%
Individual Counseling	1,050	1,216	1,070	-14%
Retirements	785	716	655	10%
Withdrawals	1,485	2,816	3,072	-47%
Deaths	278	279	265	0%
Seminars	51	53	57	-4%
Seminar Attendance	1,381	1,386	1,749	0%

Retirement Reengineering Project

The workload of the Retirement staff has increased steadily over the years as retirement plans have become more complex and the number of members has increased. In the coming years, the volume of retirements to be processed and client contacts is expected to continue to grow.

In an effort to better deal with higher case loads, to meet clients' needs in a timely fashion, and to improve customer service, an RFP was issued in October 2003 to obtain the services of a management consultant. The consultant made a number of recommendations for improving the productivity, cost-effectiveness, and internal control safeguards of the Retirement Division.

During 2004 and 2005 the Division implemented many of the recommendations included in the consultant's report. A new client-focused, service delivery model was adopted that organizes the staff into three key areas or units: employer services, member services, and accounting. The model recommended by the consultant creates a more manageable and efficient structure that will also enable staff to improve accountability and customer service. The Treasurer's Office also installed an automated telephone service to direct incoming calls to the appropriate division.

The management consultant also recommended that the Division replace its 25-year-old automated mainframe-based retirement system infrastructure with a modern and full-featured browser-based system to facilitate faster turn-around for inquiries and requested services. Such a system would also assure easier access to needed information and documents, increased accuracy of information, and timely identification of problems.

Starting In January 2005, the Division obtained the services of a consultant company to provide retirement system expertise in the procurement of a retirement benefit administration and imaging system. They hired a project manager dedicated to overseeing and facilitating this effort. It was decided that the procurement would occur in two stages. The first stage was to convert into electronic images the 1.8 million paper records that had been stored in 80 filing cabinets. Since the Office of the State Treasurer was scheduled to move to new space at the Pavilion building in October 2005, there was some urgency to complete this

Vermont Retirement Systems (continued)

task prior to the move. An extensive RFP was released on February 15th to convert the files, provide an interim imaging system, and produce microfilm and CD backup. Retirement's paper records were originals and were the only copy. This created significant risk should the files be lost or accidentally destroyed. Additionally, producing electronic images would enable the Division to comply with current public record retention requirements.

The conversion began on June 1st, and the 1.8 million images were available prior to our October move. Using the imaging system to access images has created efficiencies such as enabling staff to immediately access records from their workstation, has eliminated filing of member paperwork, and allows more than one staff member to view the records at the same time. These changes will be fully integrated with workflow functionality in an upcoming phase, creating even greater efficiencies via electronic recognition of documents and routing/ approval to the appropriate staff.

The second stage was to select a vendor to provide and implement a new pension administration system. A second RFP for a new pension administration system was released on July 12th. This comprehensive RFP detailed the procurement process and the project scope for a public retirement system implementation vendor to provide a comprehensive solution that included hardware, commodity software, pension administration software, project management, documentation, testing, implementation, integration, training, warranty, and support. A requirements traceability matrix with over 2,000 requirements was gleaned from the RFP and will be used during the project to track and verify that all requirements have been met. Proposals were due on September 14^{th}. A thorough review followed, which included client reference checks, product demonstrations, and numerous rounds of questions and answers.

In December, 2005, a vendor was selected to implement a new pension administration solution and contract negotiations began. An independent review required by statute of all large information technology projects was also conducted. (It is the responsibility of the CIO's office to conduct this review, totally independent from the Division.) The CIO's office hired an outside consultant who conducted a feasibility and cost/benefit analysis. The analysis documented the project strengths and potential risks and recommended that the project should go forward. The approvals for the contract were obtained in March, 2006, and the kickoff for the implementation of a new pension administration solution began April 3, 2006.

An acronym for the solution, **VPAS**, Vermont Pension Administration System, was selected. VPAS will be implemented in phases over three years. The Division wanted to avoid a "big bang" approach in which the entire solution is implemented at once. By delivering the solution in phases, the amount of change that must be absorbed at any one time by the members, boards, and staff can be reduced to more manageable levels.

The implementation of VPAS has been broken into the following five major phases.

<u>Initiation</u>: This initial period established

Vermont Retirement Systems (continued)

the foundation for the project and for the Division and contractor to begin working as a team. The project's scope was validated, and a work plan was built. Processes for mitigating risks, addressing issues, and controlling changes and communications during the project were documented. Two papers of fewer than 30 pages were written with an end-user, not technical, perspective, and are available upon request. One paper describes what VPAS is, and the second describes how VPAS will be implemented. This phase was completed in August, 2006.

Infrastructure: The Division's existing hardware, software, and networking infrastructure were reviewed, and the new infrastructure necessary to implement VPAS was identified, ordered, and installed. Much of the infrastructure is being housed in the Department of Information and Innovation's (DII) computer room. VPAS wants to thank the Department for its invaluable assistance in this phase. Many of the State's enterprise solutions at DII, such as security, emergency and data backup, and recovery facilities, have resulted in a stronger solution at a significant savings to the project. This phase was completed in September, 2006.

Imaging: Over two million images were moved from the interim imaging system into the new VPAS imaging solution. The new imaging solution will be used as a stand-alone system in preparation for the eventual integration with the new pension administration solution. This phase was completed in December 2006.

Membership: The Membership phase involves the activities dealing with a member prior to retirement, which includes employer reporting, production of annual statements, estimates and retirement planning, and purchases of service credit. During this phase, development, testing, training, and installation of the application solution, including the data conversion and integration with the imaging solution, will be done. The anticipated implementation of this phase is January 2008.

Benefit Payment: The Benefit Payment Phase deals with the activities of a member once they have retired, and includes pension payments, tax withholdings, and insurance deductions. The anticipated implementation of this phase is early 2009. This phase also includes a component for member self-service which would allow members of the system to access some personal retirement information via a secure Web page.

With the implementation of VPAS, every aspect of the daily business of the Division will be affected. This solution will provide the State of Vermont with a stable, state-of-the-industry, fully-integrated pension administration solution that will allow the Division to operate its business more efficiently and effectively. The system will also meet our customers' needs for increased access to services and more timely information.

Deferred Compensation Program

The Board of Trustees for the Vermont State Retirement System is responsible for a deferred compensation program that has been available since 1973 as a savings option for State employees, municipal employees, employees of

Vermont Retirement Systems (continued)

agencies such as VSAC, VEDA, and VHFA, and members of the General Assembly. 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. On June 30, 2006, the plan had 6,024 participants. Total assets in the plan were valued at $216.03 million. Participating employees made contributions in the amount of $15.957 million to the plan during FY'06.

Defined Contribution Plan

Established in 1999, the State's defined contribution plan had 592 participants and net assets of $35,285,003 as of June 30, 2006.

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 or not 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 have a choice of either plan. As of July 31, 2006, there were 77 contributing municipalities with 527 participants and net assets of $10,499,319.

Single Deposit Investment Account

The Single Deposit Investment Account (SDIA), a non-contributory defined contribution plan reported in the Pension Trust Funds, was established according to the provisions of Public Act 41 of the 1981 Session. The SDIA was intended to provide an investment vehicle in which to deposit contributions made by members of the State and Teachers' contributory retirement systems who voluntarily elected to transfer to the newly established non-contributory retirement systems. Members electing to transfer to the non-contributory plans had their choice of one of the following three options:

- have both their accumulated employee contributions and accumulated interest returned to them; or
- have their accumulated contributions returned to them and only their accumulated interest invested in the SDIA; or

Vermont Retirement Systems (continued)

- have both their accumulated employee contributions and accumulated interest invested in the SDIA.

In addition to the initial deposits made into the SDIA in 1981, there were three subsequent opportunities (in 1984, 1987, and 1990) for contributory members to transfer to the non-contributory plans and invest their accumulated contributions and interest in the SDIA. No new monies have been invested in the SDIA since 1990.

The SDIA plan currently has approximately 2,501 members and beneficiaries and has $96.2 million in assets.

Administrative services associated with the SDIA were consolidated in 2005 to provide improved customer services to our members who hold SDIA accounts and their beneficiaries. Following a competitive bidding process, Great-West Retirement Services was selected to administer the day-to-day activities of the SDIA, including maintaining all demographic and beneficiary information, processing all requests for withdrawals and minimum distributions, and maintaining member account value information.

Expanded services for the SDIA are available through Great-West Retirement Services and include 24-hour Web site access to account information, improved turn-around time for distribution requests, and access to customer service representatives through a local office in Montpelier and two account executives who travel throughout Vermont on a monthly basis.

Pension Operations

Employee and State (and employer for the municipal system) contributions made to pension trust funds and, most significantly, investment return, largely fund the operations of the retirement plans, including benefits, insurance (teachers' and state system), and administrative expenses. The results of operations for the three systems are reported in detail in Appendix A of this report. Chart #5, however, provides a synopsis of operations at a higher level. Over the past year $231,491,558 was added to the pension fund assets on a net basis and just under $811 million since 2003.

In addition to employee contributions, the State appropriates funding for pension costs associated with VSERS and VSTRS. VMERS contributions are made by municipal employees and their employers. These rates include a "normal contribution" rate and an "accrued liability contribution" rate and are calculated based upon the liabilities of each system as determined by actuarial valuations. In the case of VMERS the, plan is overfunded and there is no unfunded actuarial accrued liability.

The actuarial method for both the VSTRS and the VESRS plans are set by state statute. Through fiscal year 2005 the method used was the entry age normal (EAN) with frozen initial liability (FIL). The legislature has enacted a statute change revising the method to entry age normal without FIL for the actuarial valuation for the year ending June 30, 2006, which effectively restated the starting balance.

Under the previous method, set by State statute, the unfunded liability was

Vermont Retirement Systems (continued)

Chart #5
YEAR ENDED JUNE 30, 2006

Category	Vermont State Retirement Fund	State Teachers' Retirement Fund	Municipal Employees' Retirement Fund
SOURCES OF FUNDS			
Employee Contributions	$ 14,561,467	$ 21,884,140	$ 8,744,718
Employer Contributions	36,866,451	24,446,282	7,926,436
Other Income	1,171,516	1,180,606	228,746
Investment Income	115,146,415	130,835,585	27,697,371
APPLICATION OF FUNDS			
Retirement Benefits	53,435,617	66,272,471	7,120,325
Refunds	1,351,911	1,290,197	1,102,940
Health/Life Insurance Expenses	11,590,588	11,233,854	-
Administrative Expenses	1,329,081	1,679,883	439,983
Other Expenses	668,929	580,403	1,101,883
Addition to Net Assets Held in Trust for Pension Benefits	$ 99,369,723	$ 97,289,805	$ 34,832,140

frozen at 1988 levels. Any impact of underfunding subsequent to the "freezing" of the liability in 1988 falls to normal cost instead of being added to the unfunded liability as in more conventional funding methods. If funding levels approximate the actuarially annual required contribution (ARC), as in the case of the funding of VSERS, the effect of changing from EAN-FIL to EAN is attributable to variances between the actuarial assumptions and experience.

In the case of VSTRS, where there has been substantial underfunding of the ARC, the EAN-FIL method has had the effect of creating an improving funding ratio although the total required contribution (sum of the amortized unfunded actuarial accrued liability and normal) rapidly escalates. The unfunded actuarial accrued liability is amortized in a deterministic manner under the FIL method, making it easy for the ratio to rise from one year to the next even in the presence of substantial underfunding. The shift to the EAN method therefore has had the effect of increasing the actuarially unfunded liability and reducing the normal contribution.

Two additional material changes impact the VSTRS valuation completed for June 30, 2006. The actuarial assumed rate of return for investments was raised by .25 basis points. This reflects the beneficial effects of the Vermont Pension Investment Committee's unified pension fund investment process and was recommended by the Commission on Funding the Vermont State Teachers' Retirement System and adopted by the VSTRS Board of Trustees. The Commission was created by the Legislature to make recommendations for funding an adequate, sustainable, and actuarially sound retirement benefit plan. In addition to the recommendation to remove the FIL portion of the method and to revise the rate of return assumption, the Commission also recommended, and the legislature adopted, a change in the amortization

Vermont Retirement Systems (continued)

of the unfunded liability. The 30-year period for amortization of the unfunded actuarial accrued liability has been restarted effective 7/1/06 for VSTRS.

The actuary has estimated the change in the unfunded actuarial accrued liability between June 30, 2005, and June 30, 2006, as described in Chart #6 below. The actuarial firm retained by the State has also completed an upgrade to new valuation software. As a result, certain variances were noted, although well within generally accepted actuarial tolerance. In addition, several coding changes were made to reflect increased refinement of liabilities for level income option retirees. This variance was included with the actuarial gains and losses/experience classification noted below. Further, Charts #7-#9 on the following page reflect the funding progress for the three retirement systems based on valuations prepared by Buck Consultants. While VMERS and VSTRS are well funded, the funding for VSTRS has lagged until recently. The work of the *Commission on Funding the Vermont State Teachers' Retirement System* and the subsequent adoption of most of their recommendations by the Legislature have resulted in a significant change in the funding picture. The application of the above actuarial changes, recommended by the Commission, resulted in an ARC of $38.2 million for fiscal year 2007. The Legislature increased the base appropriation an additional $5.0 million for 2007 and used one time excess of receipts of $7.8 million and an estimated $1.2 million of Medicare D reimbursement funds to fully fund the ARC in 2007.

Development of Unfunded Actuarial Accrued Liabilties

Chart #6

Category	VSTRS	VSERS
Unfunded Actuarial Accrued Liability 6/30/2005 (prior to method change)	$138,143,845	$25,888,547
Actuarial Method Change*	176,941,130	-4,167,166
Unfunded Actuarial Accrued Liability 6/30/2005 (after)	315,084,975	21,721,381
Normal Cost	41,090,372	31,935,797
Contribution	-46,971,804	-52,599,434
Interest on Unfunded Liability, Normal Cost and Contribution	23,555,571	2,229,073
Actuarial Gains and Losses/Experience	-17,279,917	1,921,617
Assumption Change (VSTRS Rate of Return)	-56,370,762	0
VSERS Software and programming Changes		3,835,570
Unfunded Actuarial Accrued Liability, 6/30/2006	$259,108,435	$9,044,004

Charts #7- #9 Funding Progress of the Retirement Systems

VSERS

Year Ending June 30	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
2006[1]	$1,223,323	$1,232,367	$9,044	99.3%	$369,310	2.4%
2005	1,148,908	1,174,796	25,889	97.8%	349,258	7.4%
2004	1,081,359	1,107,634	26,275	97.6%	336,615	7.8%
2003	1,025,469	1,052,004	26,535	97.5%	319,855	8.3%
2002	990,450	1,017,129	26,679	97.4%	300,994	8.9%
2001	954,821	1,026,993	72,172	93.0%	278,507	25.9%
2000	895,151	967,064	71,913	92.6%	266,519	27.0%
1999	804,970	876,412	71,442	91.9%	238,281	30.0%
1998	733,716	804,501	70,785	91.2%	235,956	30.0%
1997	639,128	753,883	114,755	84.8%	227,000	50.6%

VSTRS

Year Ending June 30	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
2006[1]	$1,427,393	$1,686,502	$259,108	84.6%	$499,044	51.9%
2005	1,354,006	1,492,150	138,144	90.7%	468,858	29.5%
2004	1,284,833	1,424,662	139,829	90.2%	453,517	30.8%
2003	1,218,001	1,358,822	140,821	89.6%	437,239	32.2%
2002	1,169,294	1,307,202	137,908	89.5%	418,904	32.9%
2001	1,116,846	1,254,341	137,496	89.0%	403,258	34.1%
2000	1,037,466	1,174,087	136,621	88.4%	387,999	35.2%
1999	931,056	1,066,400	135,343	87.3%	372,299	36.4%
1998	821,977	955,694	133,717	86.0%	357,899	37.4%
1997	717,396	849,179	131,783	84.5%	364,695	36.1%
1996	570,776	700,377	129,601	81.5%	355,895	36.4%
1995	520,850	648,052	127,202	80.4%	346,975	36.7%
1994	473,229	597,851	124,622	79.2%	335,155	37.2%

VMERS

Year Ended June 30	Actuarial Value of Assets (a)	Actuarial Accrued Liability (AAL) (b)	Unfunded AAL (UAAL) (b-a)	Funded Ratio (a/b)	Covered Payroll (c)	UAAL as a Percentage of Covered Payroll ((b-a)/c)
2006	288,347	276,552	(11,795)	104.3%	148,815	-7.9%
2005	259,076	248,140	(10,936)	104.4%	146,190	-7.5%
2004	232,890	225,092	(7,798)	103.5%	135,351	-5.8%
2003	222,854	218,533	(4,321)	102.0%	126,216	-3.4%
2002	193,278	176,109	(17,169)	109.7%	106,986	-16.0%
2001	177,928	158,786	(19,142)	112.1%	101,873	-18.8%
2000	161,900	138,697	(23,203)	116.7%	87,147	-26.6%
1999	137,454	114,481	(22,973)	124.6%	70,808	- 32.4%
1998	113,678	102,005	(11,673)	111.4%	87,328	- 17.3%
1997	96,196	85,686	(10,510)	112.3%	70,800	-14.8%
1996	81,396	73,401	(7,995)	110.9%	68,700	-11.6%
1995	70,082	67,039	(3,043)	104.5%	79,056	-4.9%

Vermont Retirement Systems (continued)

The State Appropriations Bill as enacted into law included the following: "Pursuant to the recommendations of the 2005 commission on funding the Vermont state teachers' retirement system, it is the intent of the general assembly to appropriate the actuarially required contributions necessary to fund an adequate, sustainable, and actuarially sound retirement benefit plan for Vermont teachers by combining annual increases in base spending and surplus revenues as they may be available, so that the full actuarial recommendation will be funded in base appropriations by fiscal year 2010." While it is early in the process to determine the direction of the 2008 budget, there is an increased recognition of the need to fund the actuarially recommended contribution.

Other Post Employment Benefits (OPEBS)

Recently adopted rules (GASB Statement Nos. 43 and 45) by the Governmental Accounting Standards Board covering non-pension post-employment benefits (primarily health insurance) present financial and disclosure considerations for the State of Vermont beginning in fiscal year 2008. For the first time, public sector entities will be expected to report the future costs of these benefits on their balance sheets. The standards do not require pre-funding such benefits, but the basis applied by the standards for measurement of costs and liabilities for these benefits is more conservative, and therefore will result in larger yearly cost and liability accruals, if they are funded on a pay-as-you-go basis – as they presently are in Vermont and in many other jurisdictions – and not pre-funded in the same manner as traditional pension benefits.

The State's independent actuary has prepared initial valuations of the health care benefit liabilities for VSERS and VSTRS as of June 30, 2006. The Vermont Municipal Employees' Retirement System (VMERS), a cost-sharing, multiple-employer public employees' retirement system, is administered by the State but has no associated state health care benefit or liability. Component units and authorities of the State will perform their own valuation as the State does not assume the risk or financial burden for their health care costs.

The reports provide funding estimates if the state adopted the standards a year early as a means to measure the scope of the liability. Both the VSRS and VSTRS reports present two separate calculations of the State's OPEB liability, depending on whether the liability would be pre-funded or remain on a pay-as-you-go basis. For VSERS, assuming no pre-funding, the actuarial accrued liability for OPEB obligations earned through June 30, 2006, is $552.2 million. To fully amortize this liability over a 30-year period utilizing an amortization with installments increasing at a rate of 5.0% per year would require an annual required contribution (ARC) commencing at $40.9 million for fiscal year 2007, and projected to increase to $178.6 million in fiscal year 2036. However, if pre-funding is assumed, the actuarial accrued liability is reduced to $303.5 million and the ARC is calculated to commence at $25.3 million for fiscal year 2007, projected to increase to $108.3 million for fiscal year 2036. Upon retirement of the unfunded accrued liability, the projected normal cost in fiscal year 2037 on a pre-funding basis is $49.8 million. As current expected benefit

Vermont Retirement Systems (continued)

payments approximate $15.0 million, the initial expected increase in annual cost to fund the benefit is $10.3 million.

For VSTRS, assuming no pre-funding, the actuarial accrued liability for OPEB obligations earned through June 30, 2006, is $952.5 million. To fully amortize this liability over a 30-year period utilizing an amortization with installments increasing at a rate of 5.0% per year would require an ARC commencing at $76.1 million for fiscal year 2007 and projected to increase to $333.2 million in fiscal year 2036. However, if pre-funding is assumed, the actuarial accrued liability is reduced to $414.3 million and the ARC is calculated to commence at $35.4 million for fiscal year 2007, projected to increase to $151.7 million for fiscal year 2036. Upon retirement of the unfunded accrued liability, the projected normal cost in fiscal year 2037 on a pre-funding basis is $69.6 million. As current expected benefit payments approximate $13.3 million, the initial expected increase in annual cost to fund the benefit is $22.1 million.

For VSTRS, assuming no pre-funding, the actuarial accrued liability for OPEB obligations earned through June 30, 2006 is $952.5 million. To fully amortize this liability over a 30-year period utilizing an amortization with installments increasing at a rate of 5.0% per year would require an ARC commencing at $76.1 million for fiscal year 2007 and projected to increase to $333.2 million in fiscal year 2036. However, if pre-funding is assumed, the actuarial accrued liability is reduced to $414.3 million and the ARC is calculated to commence at $35.4 million for fiscal year 2007, projected to increase to $151.7 million for fiscal year 2036. Upon retirement of the unfunded accrued liability, the projected normal cost in fiscal year 2037 on a pre-funding basis is $69.6 million. As current expected benefit payments approximate $13.3 million, the initial expected increase in annual cost to fund the benefit is $22.1 million.

In making these calculations, the independent actuarial firm utilized employee data and premium information provided by the State and assumed annual medical care inflation growth initially at 8.0% for fiscal year 2007, declining to 7% for 2008, 6% for 2009 and 5% thereafter. The valuations also assumed continuation of current benefit levels and current retiree contribution requirements. The actuarial cost method used is projected unit credit.

The difference between the value of pre-funded and pay-as-you-go OPEB liabilities is due to the discount rate used in the calculation. In the absence of pre-funding, the discount rate must approximate the State's rate of return on non-pension, liquid investments over the long term, estimated at 3.75%. In the event of pre-funding, the discount rate would increase to a return on long-term investments consistent with the respective pension funds, estimated at 8.0% for VSRS and 8.25% for STRS. In order to treat its OPEB liabilities as pre-funded, the State would have to enact legislation providing for the deposit of annual contributions in an irrevocable trust, in the manner similar to the pension funds.

The State has not yet made any decision on when or how it will fund the full ARC, although it has taken several

Vermont Retirement Systems (continued)

steps. In fiscal year 2007, an irrevocable trust was established to be administered by the State Treasurer for the purpose of accumulating and providing reserves to fund retiree post-employment benefits for members of the VSERS, excluding pensions and benefits otherwise appropriated by statute. All funds remitted to the State as a subsidy on behalf of the members of the VSERS for employer-sponsored qualified prescription drug plans pursuant to the Medicare Prescription Drug Improvement and Modernization Act of 2003 will be deposited into this fund, as will any appropriations by the legislature. The State Treasurer was authorized by the legislature to contract with an independent expert to review, evaluate, and make recommendations on pension and retiree health plan provisions and design, as well as benefit and contribution levels for VSERS and VSTRS. A report has been filed for consideration.

Retirement Reorganization

In order to meet the challenges of increased demands of the on-going operations, implementation of the new computer system, maintaining compliance with changes in federal laws relating to retirement benefits, and ever-increasing need for better communication and outreach to our expanding population of members and retirees, we have taken our existing resources, re-structured some of the positions, and re-distributed the workload. The first change was to take the positions of the Director and Deputy Director of Retirement Operations and create two new positions that will work as a team, but will have separate and distinct areas of responsibilities. Michael Clasen, the former Deputy Director of Retirement Operations, is now the Director of Retirement Operations. Michael will be fully responsible for all areas of the day-to-day operations within the Retirement Division. He will also be responsible for implementation of all new programs or legislative initiatives that occur. Cynthia Webster, the former Director of Retirement Operations, is now the Director of Retirement Policy and Outreach. Some of the duties of this new position will be similar to those previously included under the Director of Retirement Operations, such as working with the legislature on retirement legislation, acting as Executive Officer for the retirement boards, and fulfilling the responsibilities of State Social Security Administrator. In addition, this new position will be responsible for ensuring the retirement statutes are updated when needed and are in compliance with applicable state and federal laws, and establishing and documenting retirement policies and procedures for all administrative functions in the Retirement Division. The final area that will be addressed by the new position is more organized and aggressive outreach to our members and retirees.

The second change that has occurred is a promotion of our senior Retirement Specialist to Retirement Specialist Supervisor. The supervisor will be responsible for training and ensuring accuracy and continuity of the information disseminated by the Specialists. The final change is to re-classify one of our accounting positions to a Financial Services Director within the Retirement Division. This new position will have responsibility for financial controls, quarterly and year-end statements, and all areas of financial reconciliation, reporting, and compliance.

Debt Management

ACCOMPLISHMENTS IN 2006

- **Vermont maintains double-A plus bond ratings and continues to have the best combined ratings of any New England state. Moody's Investors Service rates Vermont's general obligation debt Aa1 with a "positive" outlook. Vermont continues to work toward achieving an upgrade to triple-A. In Moody's *U.S. States Credit Scorecard*, an analytical tool introduced in August 2006, the State was ranked in the first tier (quintile) in three of four categories, the most of all but one other state.**

- **The State Treasurer's Office issued $45.0 million aggregate principal amount of general obligation bonds in Fiscal Year 2006. This included a $30 million competitive offering in November 2005 with a true interest cost of 4.38% and average life of 12.6 years, followed by a $15 million negotiated "Citizens Bond" offering in December 2005 with a true interest cost of 3.76% and average life of 5.1 years. The State continues to bond for capital expenditures at rates that are both historically favorable and low relative to highly-rated states.**

- **The Capital Debt Affordability Advisory Committee (CDAAC) recommended increasing the State's annual bonding level to $49.2 million in fiscal year 2008. This 9.3% increase will allow for additional funding of capital projects without deterioration of key financial ratios used by rating agencies.**

Debt Management

Bond Issues

The State Treasurer's Office issued $45.0 million aggregate principal amount of general obligation bonds in Fiscal Year 2006. This included a $30 million competitive offering in November 2005 with a true interest cost of 4.38% and average life of 12.6 years, followed by a $15 million negotiated "Citizens Bond" offering in December with a true interest cost of 3.76% and average life of 5.1 years. The Citizens Bonds, typically with shorter maturities more attractive to retail as opposed to institutional investors, are offered only to Vermont residents, in denominations as low as $1,000 instead of the more traditional $5,000 denominations.

Debt Management Approach

Historically, the State Treasurer's Office, in conjunction with the Administration and Legislature, has set a course of maintaining modest levels of new authorizations of long-term debt and net tax-supported debt outstanding. The State's debt issuance and management process has been characterized by a conservative approach designed to reduce the level and cost of debt. As a result, bond issuance is currently at substantially lower levels than in the early and mid-1990s. This factor plus continued improvement in the State's economic indices and financial condition over recent years have improved the State's debt ratios. In addition, the State's practice of issuing debt with level annual principal installments has resulted in a favorable amortization rate. At a rate of nearly 80% retirement within ten years, the State's bond payoff ratio continues to be favorably received by the rating agencies.

A major contributing factor to Vermont's respected debt management is 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 estimate of the committee is advisory, but historically has been adopted by the state as a bonding limit. CDAAC is made up of four *ex officio* members and one appointee of the governor. The State Treasurer serves as chair of the Committee. For fiscal years 2002 to 2004, CDAAC recommended a level of $39 million in new bonding each year, with a slight increase to $41 million for fiscal year 2005.

In September 2004, the Committee revised its debt management guidelines to set the recommendation for fiscal year 2006. Having met and exceeded previously established guidelines, the Committee evaluated its current debt structure and capital financing goals. As a result, it adopted new guidelines consistent with Vermont's stated objective of achieving a triple-A rating from the bond agencies. A triple-A rating is an attractive goal for a state because it offers a lower cost of capital to the State and favorably impacts the ratings and costs of borrowing for State Agencies such as the Vermont Municipal Bond Bank, Vermont Housing Finance Authority, and

Debt Management (continued)

Chart #10
Capital Debt Affordability Committee Target Guidelines

Debt Ratio	**Guideline**
Debt per capita	Moody's triple-A medians and means
Debt as Percent of Personal Income	Moody's triple-A medians and means
Debt Service to Revenues	Six Percent or Less

Vermont Student Assistance Corporation.

The Committee recommended a modest increase in fiscal 2006 to $45 million, and maintained that level the next year for the fiscal year 2007 recommendation. Continuing to use these guidelines (see Chart #10), while at the same time considering the capital demands, the Committee unanimously voted to recommend that the FY 2008 State General Obligation Debt bonding limit be set at $49.2 million, a 9.3% increase from FY 2007. The Committee considered and balanced the objectives of meeting its credit rating targets and the need to finance needed State infrastructure projects.

This level was the highest level that allows the State to maintain or improve critical ratings ratios, notwithstanding creation of modestly higher levels of debt outstanding. The Committee continues to believe that debt issuance moderation is appropriate in uncertain economic times. Finally, the additional $4.2 million of debt authorization above debt authorized for FY 2007 provides a meaningful increase in capital projects funding.

Bond Authorizations

The State has maintained a fiscal discipline designed to reduce its overall debt levels. Bond issuance is currently at substantially lower levels than in the early and mid-1990s. This factor plus continued improvement in the State's economic indices and financial condition over recent years have brought down the State's debt ratios. Chart #11 provides a historical look at bond authorizations. The State reduced its new authorizations for general obligation debt from $83.4 million in Fiscal Year 1991 to $39 million in Fiscal Year 2004. Revenue surpluses in fiscal years 2000 and 2001 resulted in full funding of statutory reserves and contributed to significant pay-as-you-go amounts being employed for funding capital improvements. While adoption of $45 million annual debt authorization levels for fiscal years 2006 and 2007 represented an increase from FY2004, these levels and the planned $49.2 million level for Fiscal Year 2008 allow for modest increases in debt outstanding and financial ratios that support attainment of a triple-A rating.

By keeping new authorizations at moderate levels, the State of Vermont

Debt Management (continued)

has reduced its total level of outstanding long-term debt (Chart #12). 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, 2006, net tax-supported debt outstanding was reduced slightly from $440.3 million to $440.0 million.

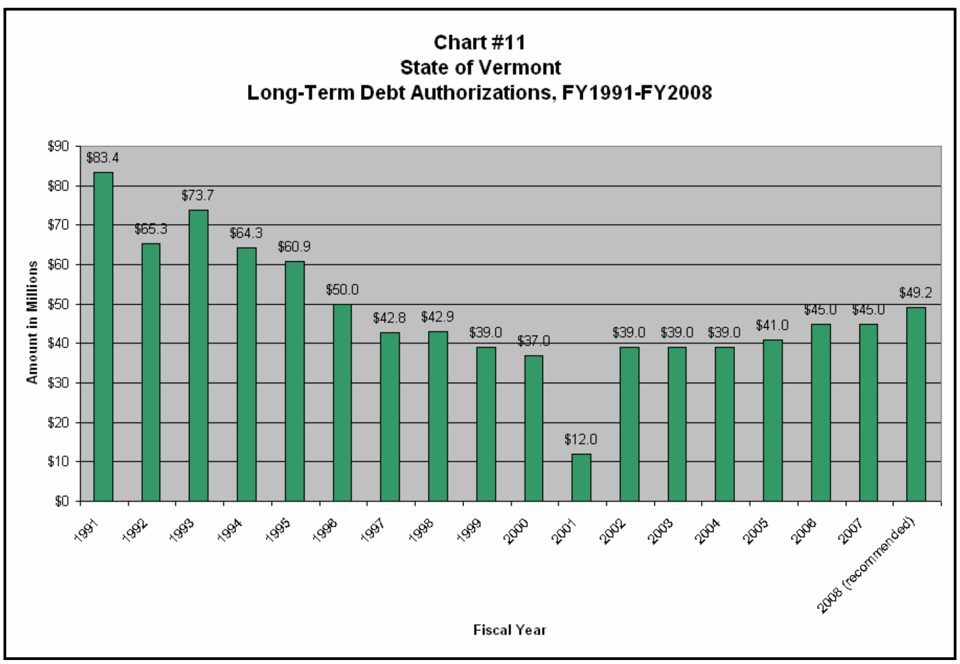
This is even more significant given that the national trend, in aggregate for all fifty states, has been to increase debt levels during this same period (see chart #11 insert). Assuming continued authorizations at the current $49.2 million debt level recommended by the CDAAC, outstanding debt is expected to increase only modestly and would approximate $470.9 million by Fiscal Year 2017.

Total debt service, i.e., the amount appropriated to pay principal and interest on bonds, is calculated at $69.1 million for fiscal year 2007, versus $67.2 million in 2006. Future debt service payments will continue to fluctuate over the next decade, and are expected to peak in FY 2010 and then moderate to or below current levels through fiscal year 2017, based on the current CDAAC model.

Bond Rating

Vermont continues to enjoy the highest composite bond rating in New England (Chart #13) and has avoided downgrades experienced by some states within the past several years.

Because a higher rating enhances the State's reputation in the municipal marketplace, it makes the bonds more attractive. As noted previously, 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 or other borrowers issuing through other State Agencies, as the



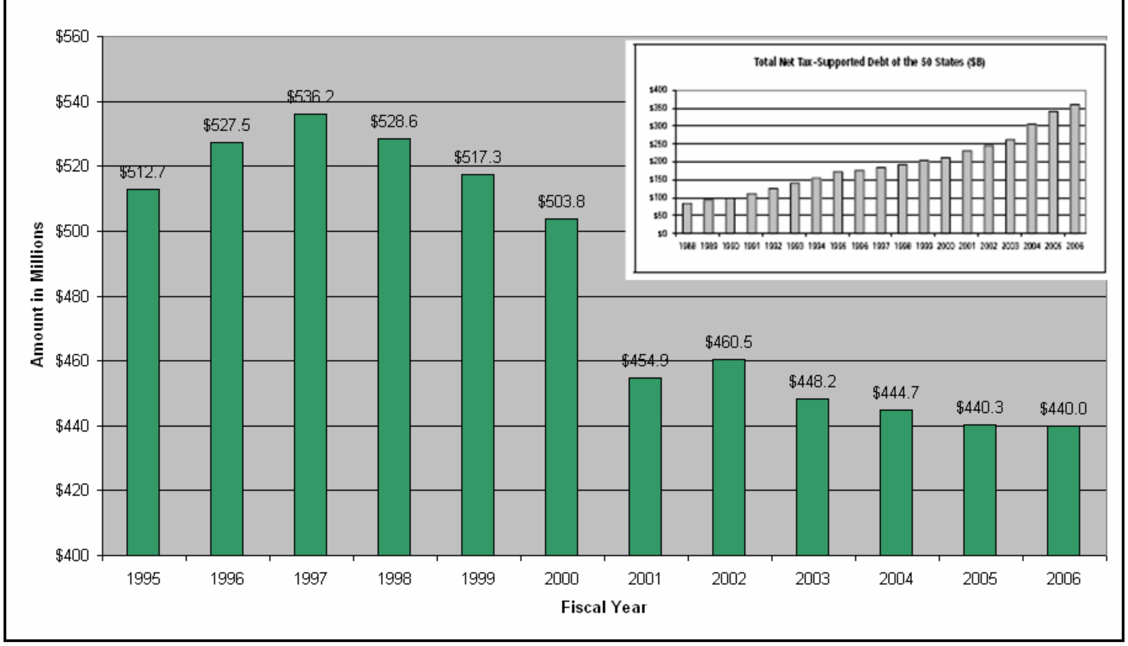


Chart #12
State of Vermont
Net Tax Supported Debt Oustanding, FY 1995- FY2006

Net Tax-Supported Debt as of 6/30/05	$440,266
G.O. New Money Bonds Issued	45,000
Less: Retired G.O. Bonds	(45,272)
Net Tax-Supported Debt as of 6/30/06	**$439,994**

General Obligation Bonds[(1)]:	
General Fund	$415,861
Transportation Fund	12,128
Special Fund	12,005
Contingent Liabilities:	
VEDA Mortgage Insurance Program	9,049
VEDA Financial Access Program	917
Reserve Fund Commitments:	
Vermont Municipal Bond Bank	477,070
Vermont Housing Finance Agency	95,205
VEDA Indebtedness	70,000
Gross Direct and Contingent Debt	$1,092,235
Less:	
Contingent Liabilities	(9,966)
Reserve Fund Commitments	(642,275)
Net Tax-Supported Debt	$439,994

Debt Management (continued)

Chart #13

New England General Obligation Bond Ratings

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

state's rating is applied to these bond issues. A high credit rating is also attractive to business development as it is a sign of economic and fiscal stability.

Debt Ratios

The fiscal discipline of recent years has paid off as Vermont's debt ratios compare favorably with triple-A states. This discipline, combined with the State's improving economic trends and financial reporting, provides a case for future bond upgrades. In FY 2006, Moody's recognized this and assigned a "positive" outlook to the State's Aa1 general obligation bond rating. The key to obtaining a triple-A rating will be to demonstrate continued diligence in these areas while making improvements on other major sustainability issues – Medicaid funding, VSTRS funding, and the funding of other post-employment benefits (OPEB). Summarized below are some of the key debt indicators for Vermont.

Debt Per Capita

One of the key debt factors monitored by the CDAAC and the rating agencies is the ratio of the State's net tax-supported debt per capita. The guideline adopted by the CDAAC establishes a target ratio of debt per capita at Moody's median and means for triple-A rated states. In 2006, the State's Debt per capita was $707 versus the Moody's triple-A median and mean of $765 and $879, respectively (Charts #14 and #15). The State's ranking versus all fifty states improved from 25th in 2005 to 29th in 2006. The higher the ranking figure, the lower a state's debt per capita is relative to all other states. While this represents an ongoing improvement, 21 States have a higher (more favorable) ranking figure.

Currently, the State's debt per capita is $703. Assuming a steady level of debt authorization and issuance of $49.2 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 be at or below this level through 2016.

Debt Management (continued)

Debt as a Percentage of Personal Income

An even more important credit factor for assessing a state's relative ability to pay its general obligation debt is the ratio of net tax-supported debt as a percent of personal income. The new guideline adopted for this ratio is again to target Moody's median and mean for triple-A rated states. The State has steadily improved in this area, and the State's ratio of debt to personal income for FY'06 dropped to 2.2% versus Moody's triple-A median and mean ratios of 2.7% and 2.8%, respectively. The State's ranking in its debt as a percentage of personal

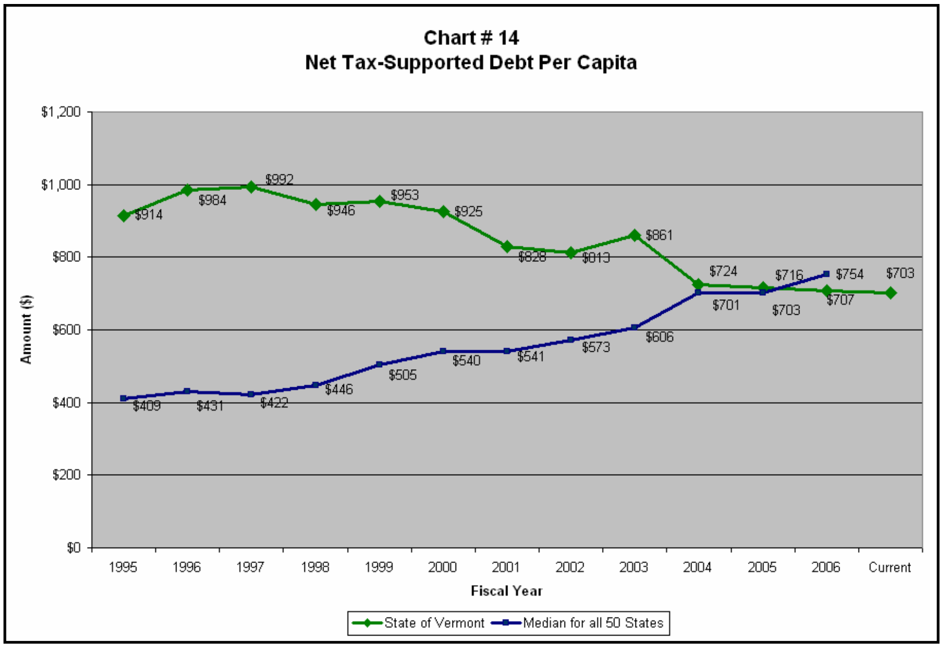


Chart #15

DEBT PER CAPITA

Triple-A Rated States	July, 2006 Ratings Moody's	S&P	Fitch	2002	2003	2004	2005	2006
Delaware	Aaa/Stable	AAA/Stable	AAA/Stable	$1,650	$1,599	$1,800	$1,865	$1,845
Florida	Aa1/Stable	AAA/Stable	AA+/Stable					976
Georgia	Aaa/Stable	AAA/Stable	AAA/Stable	804	802	827	803	784
Maryland	Aaa/Stable	AAA/Stable	AAA/Stable	879	977	1,077	1,064	1,169
Minnesota	Aa1/Stable	AAA/Stable	AAA/Stable	576	625	691	679	746
Missouri	Aaa/Stable	AAA/Stable	AAA/Stable	347	368	461	449	496
North Carolina	Aa1/Positive	AAA/Stable	AAA/Stable	375	429	556	682	804
South Carolina	Aaa/Negative	AA+/Stable	AAA/Stable	615	587	599	558	661
Utah	Aaa/Stable	AAA/Stable	AAA/Stable	708	682	846	792	707
Virginia	Aaa/Stable	AAA/Stable	AAA/Stable	566	546	546	589	601
MEAN	________	________	________	**724**	**735**	**823**	**831**	**868[1]/879[2]**
MEDIAN	________	________	________	**615**	**625**	**691**	**682**	**746[3]/765[4]**
Vermont	Aa1/Positive	AA+/Stable	AA+/Stable	813	861	724	716	707

Triple-A Rated States
5-Year Mean and Median Excluding Florida[5]:
MEAN: 796 Vermont: 764
MEDIAN: 682 Vermont: 724

Debt Management (continued)

income improved from the 27th highest among the states in 2005 to 28th highest in 2006.

Debt Service as a Percentage of Revenue

The guideline used for this ratio states that projected annual State debt service on bonds should not be in excess of six percent of projected revenues in the combined General and Transportation Funds. The debt service as a percentage of revenues ratio was 5.1% for fiscal year 2006. This percentage is expected to be below 6% through 2017, assuming the issuance of $49.2 million of debt from FY 2008 through FY 2017.

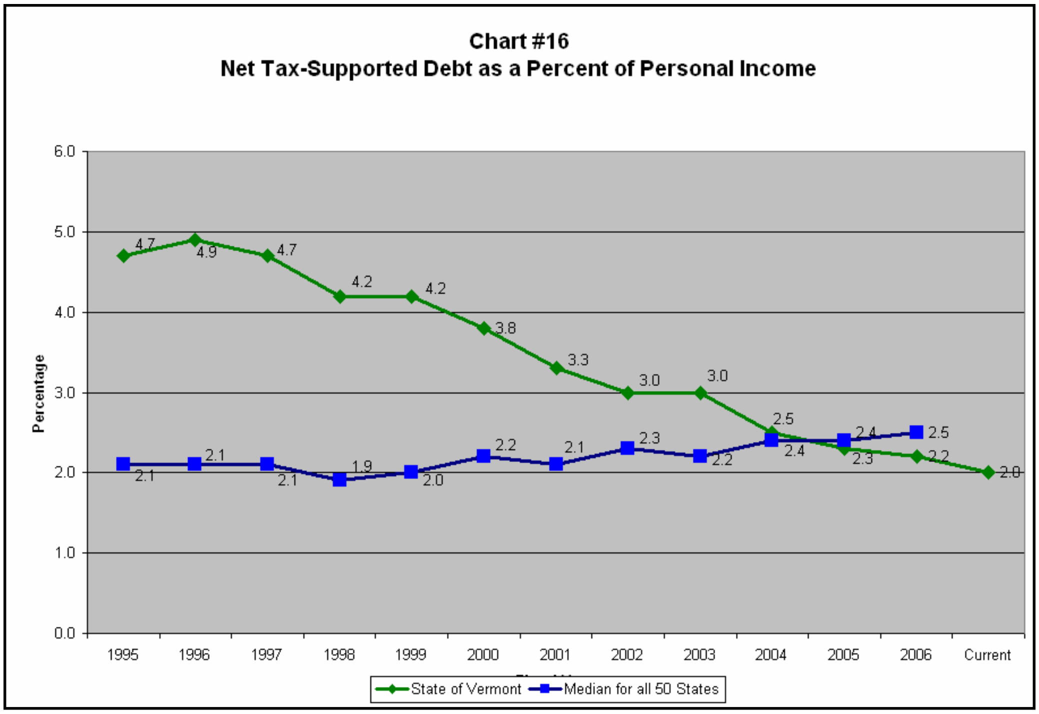


Chart # 17

DEBT AS % OF PERSONAL INCOME

Triple-A Rated States	2002	2003	2004	2005	2006
Delaware	5.3%	5.0%	5.6%	5.5%	5.3%
Florida	______	______	______	______	3.2
Georgia	2.9	2.9	2.9	2.8	2.7
Maryland	2.6	2.8	3.0	2.9	3.0
Minnesota	1.8	1.9	2.0	2.0	2.1
Missouri	1.3	1.3	1.6	1.5	1.6
North Carolina	1.4	1.6	2.0	2.5	2.8
South Carolina	2.5	2.4	2.4	2.2	2.5
Utah	3.0	2.9	3.5	3.2	2.7
Virginia	1.8	1.7	1.7	1.8	1.7
MEAN	2.5	2.5	2.7	2.7	2.7[1]/2.8[2]
MEDIAN	2.5	2.4	2.4	2.5	2.7[3]/2.7[4]
Vermont	3.0	3.0	2.5	2.3	2.2

Triple-A Rated States
5-Year Mean and Median Excluding Florida[5]:
MEAN: 2.6% Vermont: 2.6%
MEDIAN: 2.5% Vermont: 2.5%

Debt Management (continued)

Short –Term Borrowing

In the early 1990s, Vermont was issuing approximately $150 million of short-term debt obligations annually, not including $65 million in deficit notes. The State's strong cash position did not require the issuance of short-term debt in fiscal years 1999-2002 (Chart #18). As the national and regional economy placed additional stresses on governmental revenues, the State's cash position in fiscal year 2003 did necessitate the borrowing of $75 million. The situation began to rebound and, in fiscal year 2004, the short-term borrowing was reduced to $48 million for a much shorter time period, September to March.

Typically, education payments to local towns and school districts occur in September and December, while tax revenues are collected later in the year, primarily April. By April the revenue flow is generally positive.

While the State has had a line of credit available to it during the last two years, it has not had to access it, a continuing sign of improvement. While the seasonal dip continues to occur, the overall healthy cash position has further reduced the likelihood of any short-term borrowing for the current fiscal year.

The State began fiscal year 2006 with approximately $220.0 million in unrestricted cash and investments on hand and the year with $259.1 million in unrestricted cash and investments. While this cash balance does not bear a direct one-to-one relationship to fund balance, it indicated a very healthy position.

The Case for Triple- A

Vermont has been rated high double-A for many years. During this period, improvements have occurred which we believe justify serious consideration for Vermont to be rated as a triple-A credit.

Specific factors which we believe support a triple-A rating from all three agencies includes the following:

- Vermont's debt per capita and debt as a percent of personal income ratios are at or below current median triple-A levels. The State's debt service as a percent of general and transportation funds revenues is also very favorable.
- The State's reserves are at full statutory levels.
- A balanced financial position with well-funded reserves is the norm. Vermont tends not to experience severe financial swings.
- The State has not engaged in short-term or other forms of borrowing outside of general obligation bonding for capital projects for the last three years.
- Vermont has one of the lowest unemployment recent histories in the country, with an increasingly diverse economy.
- Two of the State's three pension funds are fully funded. The third, the State Teachers' Retirement

System, has recently taken steps such that actuarially required annual contributions are within reach and will reduce the unfunded liability over a period of years.

- Conservative debt management has been institutionalized as a priority for the State as evidenced by:
  - the work of the Capital Debt Affordability Advisory Committee;
  - the Governor and the General Assembly have always followed the CDAAC recommendation;
  - Lower debt load has had a positive effect on long-term fixed costs of running government; and
  - Increased financial flexibility.

In order to communicate the State's strengths to the agencies in support of this ratings goal, this office has conducted a number of activities to present its case.

In November 2005, a delegation of Vermont officials including the Governor, Treasurer, State Auditor, Secretary of Administration, and a senior member of the Capital Debt Affordability Advisory Committee went to New York to visit all three agencies and to share the State's positive operating results, strong financial position, and moderate debt management practices through dialogue and written presentation.

The Treasurer hosted two of the rating agencies in Vermont on two separate days so that senior ratings analysts could appreciate other factors such as the strength and depth of the State's economy and the commitment of both the executive and legislative branches to strong debt discipline. These days included meetings with key legislators, members of the administrative and treasurer's staff, and on-site visits to three important employers in the State.

In the summer of 2006, Vermont was ranked in the top quintile for three of four categories of Moody's U.S. States Credit Scorecard. This Scorecard ranks states in the areas of finance, debt, economic, and governance variables. Only one other state is ranked higher than Vermont. While pleased with this overall ranking, the Treasurer's staff, with the assistance of the Administration and the Joint Fiscal Office, compiled responses to the governance variables that support a top quintile ranking in this category as well.

We believe that an increase in the bond rating will assist the State in obtaining even better rates as it issues bonds and look forward to a continuing dialogue with the rating agencies.

Chart #18

STATE OF VERMONT
APPROACH TOWARD ESTABLISHING DEBT RATIO GOALS
Comparative Mean Debt Ratios*

Per Capita	2002	2003	2004	2005	2006
All States	$ 810	$ 838	$ 944	$ 999	$1,060
Triple-A**	724	735	823	831	868
VERMONT	**813**	**861**	**724**	**716**	**707**
% of Pers. Inc.	**2002**	**2003**	**2004**	**2005**	**2006**
All States	2.7%	2.7%	3.1%	3.2%	3.2%
Triple-A**	2.5	2.5	2.7	2.7	2.7
VERMONT	3.0	3.0	2.5	2.3	2.2

* Based on data provided by Moody's Investors Service and excluding Florida.
** Ten states currently rated triple-A by one or more of the nationally recognized rating agencies: Delaware, Florida (since 2005), Georgia, Maryland, Minnesota, Missouri, North Carolina, South Carolina, Utah and Virginia.

Investments

ACCOMPLISHMENTS IN 2006

In FY 2006, the management, composition, and structure of Vermont's pension investments underwent their most significant changes in decades. Accomplishments for pension and other investments since last year's Treasurer's Report include the following:

- **The Vermont Pension Investment Committee (VPIC) made investment decisions for the State Employees', State Teachers', and Municipal Employees' Retirement Systems for VPIC's first fiscal year ending June 30, 2006. This 17-member committee comprises all board members of these three retirement systems. This structure allows for timely and optimal asset allocation and investment manager decisions including adoption of innovative new asset classes.**

- **By the end of FY 2006, over 90 percent of VPIC investment assets were transitioned to new managers or consolidated with existing managers. These transitions, both externally and internally managed, were effected at minimal transitional costs. Initial performance of VPIC investments following unitization and transitions to new managers is very favorable in both relative and absolute terms.**

- **As of October 1, 2006, all VPIC investments (with the exception of several small private equity accounts) are held in "unitized" accounts shared by each retirement system. Unitization has aggregated assets held by the three systems to allow for lower investment management fees and to facilitate selection and sharing of best in class managers across all asset classes.**

- **Combined assets of the three State Pension Plans reached the $3 billion milestone in August, 2006. This asset growth was partly due to superior investment performance under VPIC administration. At September 30, 2006, all three systems' one-year performance ranks were in the top quintile of public funds.**

- **The Treasurer's Office continues to find opportunities to invest, including a decision to commit $2.5 million to a mutual fund that will make an equivalent investment in Vermont housing and other Vermont fixed income securities.**

Investments

Pension Fund Investments

The State Treasurer's Office administers the investment policies and strategies adopted by the Vermont Pension Investment Committee which in turn oversees all investment assets held by the Vermont State Employees' Retirement System, the State Teachers' Retirement System of Vermont, and the Vermont Municipal Employees' Retirement System. The three systems had combined assets of approximately $2.92 billion on June 30, 2006, and combined assets exceeded $3 billion for the first time in August 2006. Asset levels have continued to rise on a long-term trend consistent with national trends in pension portfolios. The growth in assets is displayed in Chart #19 below.

In Fiscal Year 2006, one-year investment returns remained above the actuarial target (8 percent) for the three principal Vermont Retirement Systems: 10.4% for the Vermont State Teachers' Retirement System (VSTRS), 10.6% for the Vermont State Employees' Retirement System (VSERS), and

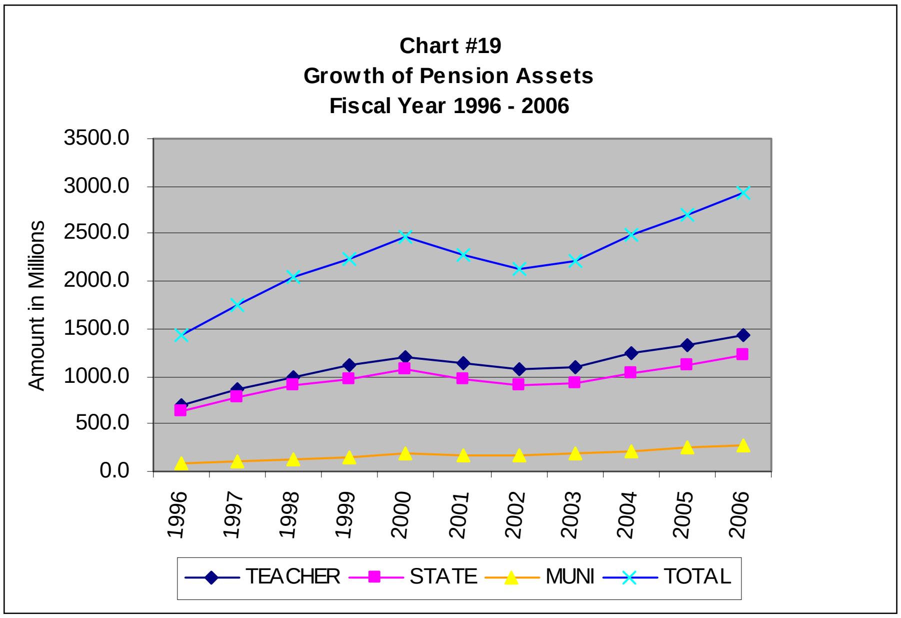


Chart #20
Long-term Investment Performance Of Vermont's Retirement Systems
As of June 30, 2006

Retirement System:	Last 1 Year	Last 3 Years	Last 5 Years	Last 7 Years	Last 10 Years
Teachers Composite (Gross)	10.4%	11.9%	7.1%	6.0%	9.1%
State Composite (Gross)	10.6%	11.7%	6.7%	5.4%	8.6%
Municipal Composite (Gross)	11.3%	11.4%	6.7%	5.7%	9.5%
Median Public Fund	9.3%	11.3%	6.3%	5.3%	8.5%

Investments (continued)

11.3% for the Vermont Municipal Employees' Retirement System (VMERS) (Chart #20).

For the ten years ended June 30, 2006, the median public retirement plan in the United States had an average annualized total return of 8.5%, compared with 8.6% for VSERS , 9.1% for VSTRS, and 9.5% for VMERS. Vermont's retirement pension plans have outperformed and continue to outperform the majority of public pension plans over multi-year periods.

Asset allocation is essential to the investment performance of the plans. 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. VPIC asset allocations are also significantly diversified in order to maximize overall returns with acceptable portfolio risk. Each system's assets are invested in stocks, bonds, real estate, and global asset allocation strategies, with an additional small allocation to alternative investments, such as venture capital partnerships (Chart #21).

FY 2006 marked the culmination of VPIC asset allocation and investment decisions whereby over 90% of VPIC assets were transitioned to new or consolidating managers. Included in this transition were allocations to two new managers in a new asset class, Global Asset Allocation (GAA). VPIC assets within this class include index funds, index futures, mutual funds, and other vehicles which GAA managers use to take advantage of asset class pricing anomalies to create incremental returns. These assets are thus invested tactically

Chart #21
Asset Allocation of Pension Funds as of June 30, 2006

Investment Category	Teacher	State	Municipal
Domestic Equity			
Large Cap	30%	25%	26%
Small Cap	12%	12%	10%
Total	42%	37%	36%
Domestic Fixed Income			
Core	16%	21%	25%
High Yield	5%	5%	5%
Total	21%	26%	30%
International Equity	14%	14%	14%
Global Fixed Income	5%	5%	3%
Global Asset Allocation	10%	10%	10%
Real Estate	8%	7%	7%
Other	0%	1%	0%
Total	100%	100%	100%

Investments (continued)

on a daily basis, unlike traditional asset classes.

Other assets transitions occurring since the last annual report include core, high yield, and global fixed income categories. A new core fixed income manager was selected replacing two prior managers. As with almost all VPIC accounts, fixed income assets from all three systems are now invested in a single separately managed account, allowing for favorable fee terms to be shared by each retirement system. These fee savings combined with the manager's out-performing the benchmark allow all three systems to share in above-median returns for the category.

The VPIC elected to retain an existing high yield manager and consolidated assets from all three systems into a single high yield separately managed account. Finally, in the global fixed income category, a new manager was added to an existing manager allowing for global fixed income assets to reside on two unitized accounts. As of December 2006, VPIC is considering additional enhancements to its fixed income assets.

In calendar 2006, the VPIC continued to diversify real estate holdings of the retirement systems by adding new managers in the "value-added" category. Value-added managers purchase real estate properties considered to be sub-prime due to vacancy, physical condition or other factors. These properties are then released or otherwise improved to be later sold as prime properties. Traditionally the three Vermont Retirement Systems have invested only in "Core" real estate: prime properties in major urban areas. As advised by its investment consultant, the VPIC determined that there are currently better return prospects in the value-added category than in core real estate.

Other VPIC accomplishments include formation of Investment Search and Investment Policy subcommittees, adoption of a policy relating to investing in companies involved in genocidal or terrorist states, and committing to multi-year private equity investment programs. Searches based on Requests for Proposals for an investment consultant and for a custodian also were conducted, and resulted in re-engaging current vendors on favorable terms.

Proxy voting guidelines adopted in March 2004 continued to be in effect in FY 2006. These guidelines have been observed by investment managers since policy inception. In FY 2006, a decision was made by VPIC to engage a proxy voting firm to vote both domestic and foreign equity proxies in accordance with this same policy. VPIC has entered into a contract on favorable terms with this vendor; transition to this form of voting is in place for the upcoming proxy season in 2007.

The Policy's corporate governance guidelines include voting policies relating to boards of directors, auditors, shareholder rights, and executive and director compensation. The Policy's corporate responsibility and accountability guidelines include voting policies on environmental issues such as global warming and environmental reporting, as well as workplace issues such as equal employment opportunities, human rights, and labor codes. A copy of this policy may be obtained on the Vermont Treasurer's Web site.

Investments (continued)

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, 2006, the fund had a principal balance of approximately $49.7 million, of which $35.2 million was allocated to the Tobacco Trust Fund, $11.2 million to the Higher Education Endowment Trust Fund, and the remainder to various smaller trust funds. The fund has now reached the $50 million milestone.

The current target allocation of the Trust Investment Account is 70% fixed income securities and 30% equities. For FY'06, the fund had a total return of 5.9% versus the target return of 2.2%., which is derived based on its asset allocation and the performance of the S&P 500 Stock Index (8.6%) and the Lehman Aggregate Bond Index (–0.8%).

The Treasurer created an Investment Advisory Committee (IAC) to advise on investment policies and decisions primarily for the State's Trust Investment Account but also as an additional source of ideas for the State's pension plans and shorter-term funds. This Committee first met in November 2004. Since that time, the IAC has advised the Treasurer and his staff on important investment matters including:

- Asset Allocation for the Trust Investment Account;
- Creation of an Economically Targeted Investment Policy (TIA and Pension Funds)
- Review of TIA Investment Managers
- Selection of an ETI Manager for the TIA

In addition to the Treasurer and two staff members, the Committee includes Dan Dibartolomeo, President of Northfield Information Services, an investment quantitative analysis firm; Derek Hammel, Investments Manager, Middlebury College; John Snow, formerly an executive with State Street Global Advisors; and Elizabeth Glenshaw, of the Calvert Foundation

With the assistance of the IAC in September 2006, the Treasurer's office made a decision to invest $2.5 million of Trust Investment Account assets in a mutual fund that invests in public housing and other fixed income securities throughout the United States. The fund, Access Capital, will make an equal investment in Vermont securities. Access Capital is a mutual fund that allows investors to target their investments in their chosen portion of the United States. The Fund invests in AAA/credit quality community economic development investments, usually specially created mortgage-backed securities (MBS).

It is expected that the ETI program must target risk-adjusted, market-rate returns and provide net returns equivalent to or higher than other available investments, at commensurate levels of risk.

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 fiscal year 2001, $635,881 at the end of FY'02, and $2,363,355 in FY 2006. On June 30, 2006, the fund had a market value of $11,188,699. In August of 2006, the State Treasurer authorized the distribution of 5% of the average market

Investments (continued)

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 entity received $156,365.08 to be applied as non-loan financial aid to Vermont students attending Vermont post-secondary institutions.

The Higher Education Endowment Trust Fund Act further provides that contributions shall include "… in any fiscal year in which a general fund surplus exists and the general fund stabilization reserve is funded to its required statutory level, funds raised by the estate tax under chapter 190 of Title 32 which are more than 125 percent of the amount projected by the emergency board in the July annual forecast made pursuant to section 305a of Title 32." For the second straight year a substantial contribution from this provision was made: $5,223,449.94 derives from fiscal year 2006, and this contribution became part of the Higher Education Trust Fund in July 2006. In addition, pursuant to legislation introduced by the Treasurer, all unclaimed property worth less than $100 under state custody for ten years or longer is to be turned over to the Higher Education Trust Fund. In the first year of this provision deriving from fiscal year 2006, $600,000 was added to the Fund in FY 2007. Thus the Fund's investment base is significantly increased for fiscal year 2007; depending upon investment market conditions, it can be expected to generate additional returns to the Fund.

Chart #22

Vermont's Expected and Actual Receipt of Tobacco Settlement Funds

Fiscal Year	Expected* ($ millions)	Actual* ($ millions)
2001	$28.47	$24.68
2002	34.18	30.92
2003	34.51	30.55
2004	28.80	25.82
2005	28.80	26.21
2006**	28.80	21.90
2007**	28.80	21.90
2008**	29.37	$33.30 to $35.30

* Source: JFO. Expected amounts shown are at time of initial settlement

** Actual column is estimated.

In addition to the above disbursements from the fund, the Vermont Commission on Higher Education Funding authorized the Treasurer to make available the additional 2% distribution of $187,638 to be divided equally between the University of Vermont and the Vermont State Colleges for application to their respective permanent endowments. In FY'06, the additional endowment allocation will be $93,819 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 C.

Tobacco Litigation Settlement Fund and the Tobacco Trust Fund

In November 1998, Vermont was one of 46 states to enter into a settlement agreement 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, with an additional $156 million of strategic contribution payments to be paid between 2008 and 2017. Through FY 2006, the State has received payments that total $195.4 million.

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 an 11.1% decrease. It remains difficult, therefore,

Investments (continued)

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 ("Settlement Fund") to be administered by the State Treasurer and to be subject to further appropriations. In Fiscal Year 2006, $18.3 million from the Settlement Fund was directed to healthcare services (Medicaid; includes $1.05 million redirected to the Medicaid Global Commitment Fund). A total of $5.2 million was spent on programs in various departments for tobacco enforcement, prevention and education programs. Additionally, $3.6 million funded substance abuse and youth protection programs in the Agency of Human Services. In FY 2007, the legislature has appropriated $19.3 million for Medicaid health services (includes $2.05 million redirected to the Medicaid Global Commitment Fund); $4.9 million for enforcement, prevention, and education; and $3.1 million for substance abuse and youth protection programs.

Any remainder of the Settlement Fund receipts is earmarked for the separately established Tobacco Trust Fund, a trust established to eventually endow the education and prevention programs. In FY 2006, there was a shortfall in funds received by the Settlement Fund due to an amount withheld by tobacco companies. This required a withdrawal from the Tobacco Trust Fund of $2.54 million. The balance of the Tobacco Trust Fund net of this withdrawal at June 30, 2006, was $30.2 million.

Vermont Veterans' Home

By legislative act in FY 2001, the Vermont Veterans' Home was required to transfer its endowment fund to the State for administration by the State Treasurer. In the fall of 2001, the Home transferred $455,441.85 in trust 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 the Board's September 2002 meeting, a spending policy was adopted that allowed for transfer of the funds to a fund in the State's Trust Investment Account ("TIA"). Of the amount transferred, $400,000 was deposited in the TIA fund 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 TIA fund as a second, separately-named fund pursuant to the terms of the bequest. On July 1, 2004, an additional contribution of $75,000 was credited to this second fund.

During fiscal year 2006, withdrawals from the Vermont Veterans' Home TIA Funds totaled $48,675. As of June 30, 2006, the balance of the fund first contributed to the TIA was $473,158.48, and the balance of the second (later) fund was $554,428.09, for a combined total of $1,027,586.57.

Short-Term Investing

The State Treasurer's Office manages the investment of the State's cash in its short-term investment program. The short-term portfolio earned $7.33 million in interest income in fiscal year 2006 on average daily available balances of $180.14 million. Of this amount,

Investments (continued)

$3,453,677.90 was credited to interest earning funds, and the balance of $3,879,227.33 remained in the general fund. The yield on the available cash in the portfolio was 4.07% for the year, which exceeded the average three-month treasury bill auction rate of 4.06%. The Treasurer's Office solicits offerings daily from the institutional trading desks of a number of national and local brokers in order to achieve maximum rate of return and diversification in the portfolio.

Bank in Vermont Initiative

In August 2004, the Treasurer's Office initiated the *Bank in Vermont* Program to invest state funds on a predictable basis through CDs via a competitive bidding process in banks with branches in Vermont. The program is designed to be attractive to the wide range of banking institutions in Vermont, and is predicated on the belief that investing Vermont funds in Vermont, consistent with earning a competitive rate of return, is a good policy.

Banking institutions that wish to be placed on a list of eligible institutions must complete an application/ questionnaire. The responses are used to evaluate prospective candidates wishing to provide investment services for CDs, and to determine maximum levels of participation based on the bank's size, financial health, risk factors, credit ratings, and capital levels.

Banks so pre-qualified are then eligible to participate in a monthly competitive bidding process for certificates of deposit. Banks that have been pre-qualified are notified in writing and/or e-mail in advance of this schedule, and bidding is done on a Web site designed by the Treasurer's Office. A block of funds is set aside for the scheduled bid in specified time frames. Some of the funds may be short duration, while a portion is set aside for longer maturities, depending on the yield curve.

As of December 31, 2006, these 18 banks have been pre-qualified to participate:

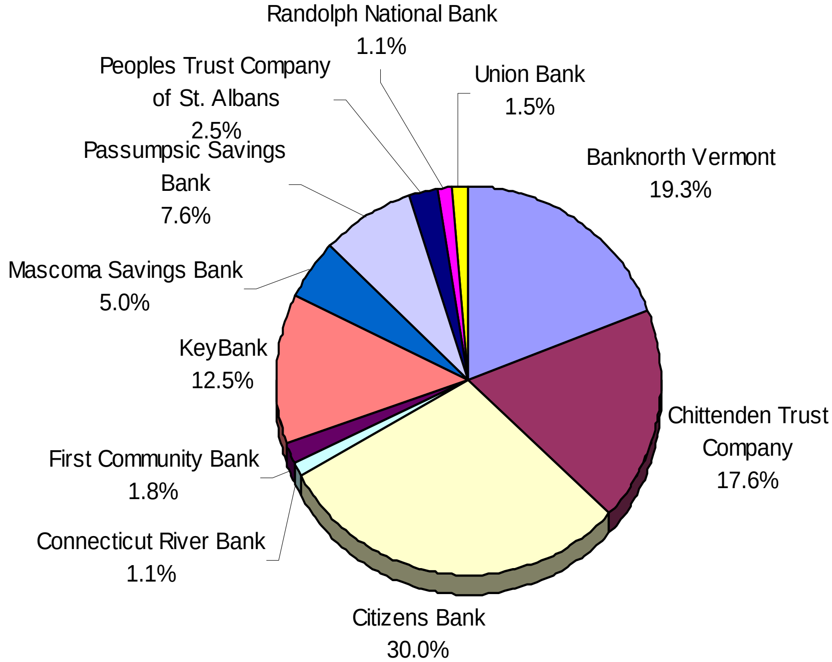
- Citizens Bank
- Chittenden Trust Company
- Connecticut River Bank
- Factory Point National Bank NA
- First Brandon National Bank
- First Community Bank
- Key Bank
- Lyndonville Savings Bank and Trust Company
- Mascoma Savings Bank
- Merchants Bank
- National Bank of Middlebury
- Northfield Savings Bank
- Passumpsic Savings Bank
- Peoples Trust Company of St. Albans
- Randolph National Bank
- TD Banknorth Vermont
- The Bank of Bennington
- Union Bank

Since its inception in August 2004, $234.5 million in Certificates of Deposit (CDs) had been awarded through December 2006. As of December 31, 2006, $35.1 million is invested in certificates of deposit of varying maturities with rates well above comparable maturity Treasury rates.

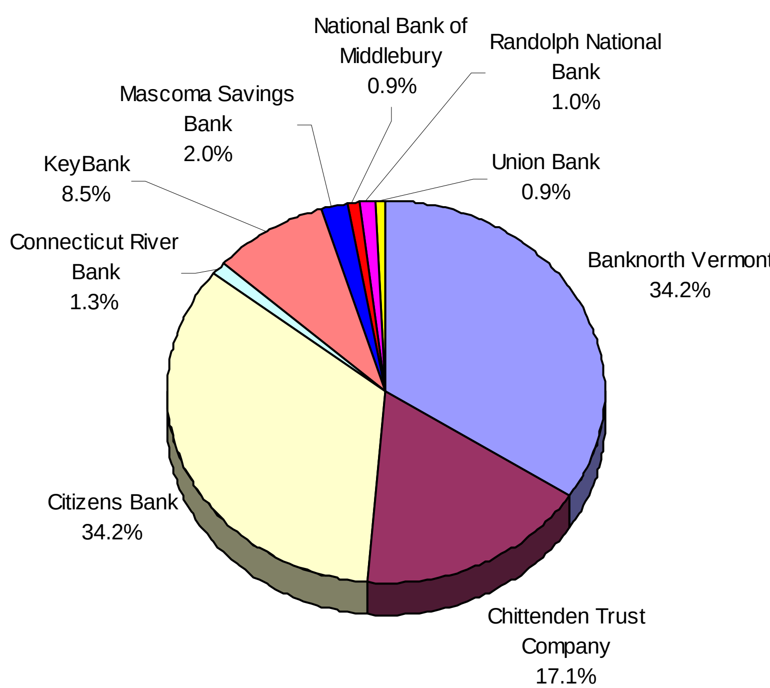
Investments (continued)

Charts #23 and #24

Bank In Vermont Distribution as of June 30, 2006



Bank in Vermont Distribution as of December 31, 2006



Financial Operations

ACCOMPLISHMENTS IN 2006

- **Completed all reconciliations within 30 days of the monthly close of the State's books for nearly three consecutive years.**
- **Worked extensively with the Department of Human Resources to automate garnishment processing. These increased efforts resulted in the migration from a totally manual system over to a PeopleSoft product run in conjunction with HR payroll processing.**
- **Increased efficiencies and real-time office-wide labor tracking within the Financial Operations Division have allowed for better capturing of current expenditures and projecting future expenses to budget submissions.**

Financial Operations Staff

From left to right: Front row, Lisa Gilman, Becky Brockway, Gayle Rowe, and Joanne Costantini. Back row: Skip Perkins, Dan Currier, Michael Healy, and Ron Baldauf.

Financial Operations Division

Overview

The Financial Operations Division is the core operation for all money movement within the State. This division is responsible for banking and cash management for over $4 billion; the disbursement of funds and the collection of receipts, including those related to Act 68; the establishment and maintenance of the State's banking network; and the recording of accounting transactions associated with the above activities. In addition, it is responsible for preparing financial statements and schedules for the annual audit of the State's books as it relates to cash and investment disclosures, the municipal equipment loan fund, and the pension trust funds.

The Financial Operations Division processes approximately two million payments each year. More than half of those are conducted electronically, and the division's goal is to continue increasing the proportion of transactions that occur electronically.

The division's workload involves extensive interaction with the commercial banks that maintain accounts on behalf of the State, the various agencies involved with the disbursement and collection of funds, and the Department of Finance and Management.

The reconciliation of internal and external accounts comprises a major portion of the office's staff time, in addition to the proper reporting and recording on the State's books for financial reporting.

Reconciliations and Electronic Payments

The Treasurer's Office staff reconciles approximately 30 State core bank accounts. In fiscal 2006, over $4 billion in various deposits were processed to state accounts through a network designed to accelerate the collection of cash so that it may be used for operating needs or efficiently placed in short-term investments.. On the disbursement side, over two million payments were processed, either through paper checks or electronic payments. Reconciliation procedures implemented by the State Treasurer's Office have effectively eliminated the likelihood of fraud, thereby protecting the State's assets. Staff activities are segregated so that one individual doesn't have the ability to both initiate and record payment activity. Joint reviews of outstanding reconciling items with agencies/departments state-wide have resulted in the resolution of important procedural and system issues, thereby significantly reducing the amount of aged items on the reconciliations.

Working cooperatively with all the Treasury's business partners, we assured that the number of user/ department reconciling items remains in check, reporting issues improve, and new procedures are continually being reviewed. The Treasury has completed all bank reconciliations within 30 days of the monthly close of the State's books for nearly three consecutive years.

The issuance of paper checks is labor-intensive and costly. In addition, there are added costs for reconciliation. Tracking of lost checks and uncashed checks is time-consuming and can be largely eliminated through electronic processing. This past year 1,700 replacement checks were issued because payees misplaced or lost the original checks. While this is down from

Financial Operations Divisions (continued)

2,400 the prior fiscal year, it involves extensive research and reconciliation work on the part of division staff, and is an inconvenience to the customer. Moving further from a paper-based payments system to electronic forms would provide increased safety, while at the same time reducing operational costs. Of the two million payments processed in 2006; 58% were electronic transfers, up from 37.0% the previous fiscal year.

In December of 2006, 85.5% of retired municipal employees, 91.5% of retired State employees, and 94% of retired teachers received their monthly benefit payments via direct deposit. This is an increase from the December 2005 percentages of 84%, 90%, and 93% respectively. Currently, 7,982 State employees, or 83% of the work force, have their biweekly pay deposited directly to their bank accounts. This is up from 7,684 the prior year.

Banking Services

TDBanknorth serves as the State's master banking contractor. Bank personnel and Treasury staff work together continuouslly to provide new, improved services and processes, with the goal of greater efficiency. Check images are available on-line for 90 days. This eliminates the need for staff to obtain CDs for the more recent check images that must be researched. Treasury personnel have secure access to up-to-the minute account information; initiate wire transfers and automated transfers of funds; process stop-payments; utilize reporting functions; and access check services. They are assured of secure messaging. All these features are complementing the effort to improve cash-flow forecasting and funds management.

Act 68 Receipts

The Treasurer's Office monitors the receipt of payments mandated by Act 68 after the Departments of Education and Taxes have notified towns and school districts of their respective liabilities. In FY'06, all towns and school districts made their Act 68 payments.

As of December 31, 2006, all districts except one made their Act 68 payment that was due on December 1, 2006, as required. The Treasurer's Office has conferred with the delinquent entity to encourage compliance, and calculated interest on the late payment. As in the past, unresolved delinquencies are referred to the Office of the Attorney General for collection

Unclaimed Property

ACCOMPLISHMENTS IN 2006

- Returned $4.5 million to 7,606 claimants.
- Enhanced compliance procedures for business and others holding unclaimed property.
- Collected $7.9 million in unclaimed property in Fiscal Year 2006.
- Completely updated the unclaimed property statute, enhancing customer access to funds and encouraging holder compliance.
- Initiated an “express claims service” to expedite payment of funds to claimants.
- There is almost 40 million dollars’ worth of unclaimed financial property in Vermont.

Unclaimed Property Staff

From left to right: Kitty Bolduc, Al LaPerle, Linda Bouffard, and Irina Aylward.

State of Vermont

HONORS

Office of the State Treasurer
Unclaimed Property Team

As an Outstanding State Team for demonstrating
commitment, talent, and leadership in public service.

Public Service Recognition
May 1, 2006

James H. Douglas
Governor

Linda P. McIntire
Commissioner of Human Resources

Congratulations to our Unclaimed Property Team, the Treasurer's Office nomination to the Governor's 2006 Public Service Recognition Program.

Unclaimed Property Division

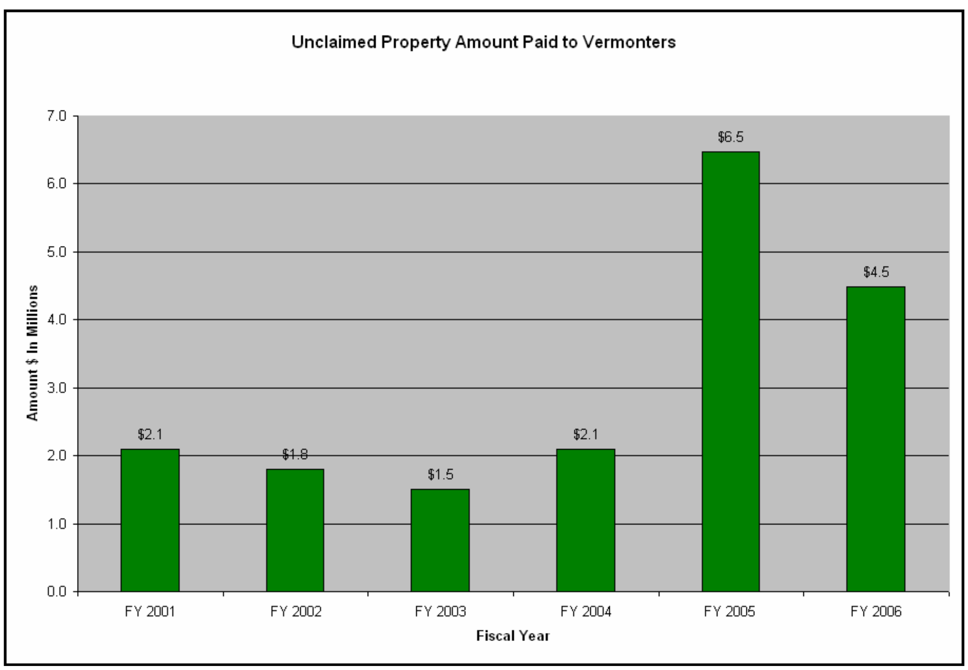
The primary function of the Unclaimed Property Division is to locate and return various forms of unclaimed financial property to the rightful owners or their heirs. This property could be forgotten bank accounts, uncashed pay checks, unclaimed security deposits, unused gift certificates, etc. It is most often in the form of money, but it can also be stocks, mutual funds, or contents of safe deposit boxes. The property comes from many sources including banks, credit unions, corporations, utilities, insurance agencies, retailers, and governmental agencies throughout the United States. The Vermont State Treasurer's Office acts as custodian to safeguard the assets until they can be claimed by the rightful owners or heirs.

In fiscal year 2006, $4.5 million in claims (Chart #25) was paid to 7,606 claimants (Chart #26). The average claim paid was $592. In addition to processing more claims, the Office has implemented a new “Express Claims” Service. The express claim service allows claimants who are the original owner and the amount is less than $200.00 to have the claim processed within five working days.

The express claim service is just an example of some of the improvements that the claims process has made in the last year as part of a long-term plan to increase customer service and outreach. In the last year, the Unclaimed Property Division has increased the outreach by setting up informational displays at events such as the Champlain Valley Exposition, the Yankee Sportsman Classic, and the 50+ Maturity Exposition. The Unclaimed Property Division has also sent listings of individuals who are listed on the unclaimed property data-base to legislators and all town clerks in the state. We appreciate their reaching out to citizens to make them aware of property being held in their name.

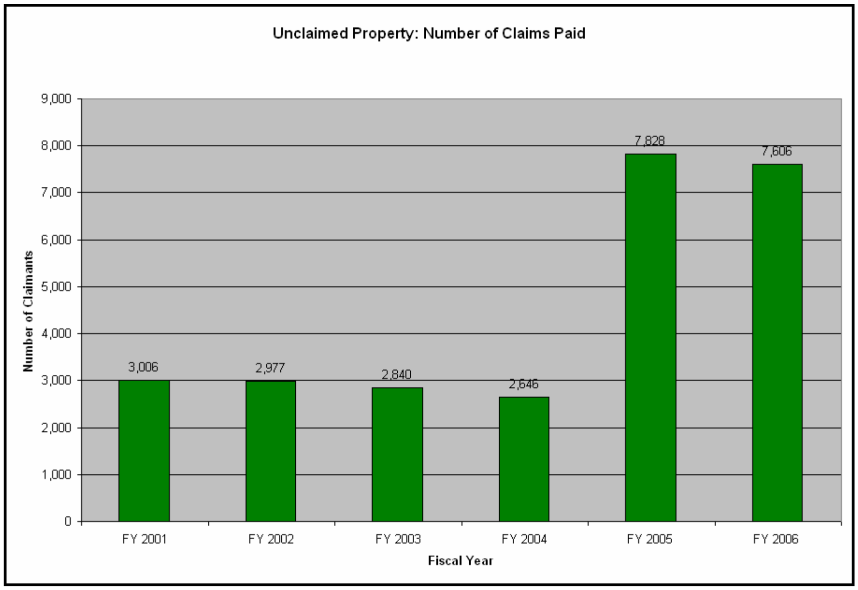
In the past year we have run a series of radio ads that have had a positive impact on our claims inquiries and payments. The radio ads directed individuals to

Chart #25



Unclaimed Property Division (continued)

Chart #26



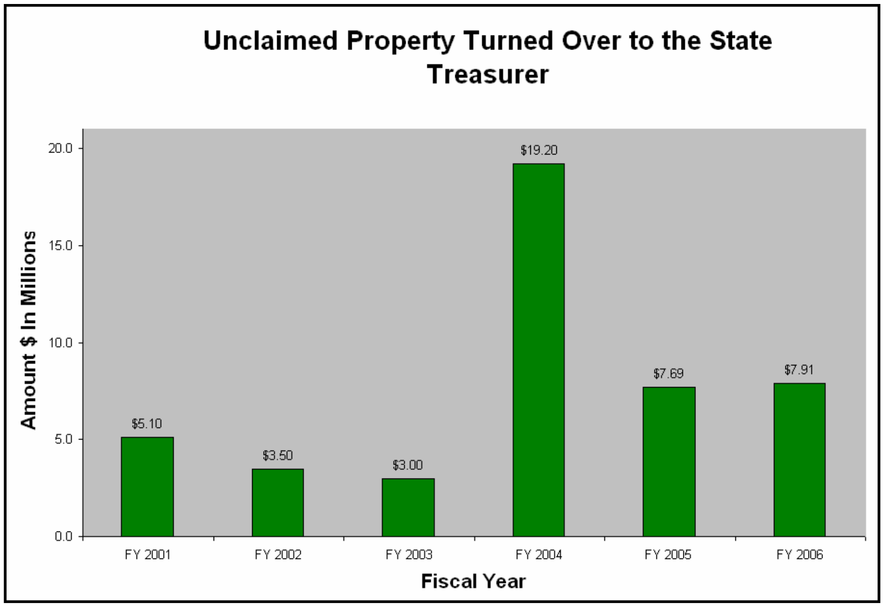
search our Web site for any funds that might be due them. These ads contributed to the record number of searches on the unclaimed property Web site. Along with the radio ads, the division continues to produce the print insert in all the daily papers in the state and to forward additional inserts to over 200 state libraries.

Vermont's unclaimed property statute was updated effective July 1, 2006. It contains a number of improvements over the old law, including clearer definitions, a more flexible approach to notifying the public about the identities of property owners, and greater flexibility in the sale of property. One important provision provides additional income to the rightful owner. Owners will receive any income or gain realized on property that is not money until the time of sale. This means that owners of stock, for example, would be entitled to dividends and splits up to the time that the Treasurer liquidates the shares and turns them into cash. The revised statute also changed the amount exempt from probate from $1000 to $2500. This was done on the basis of a recommendation from various Probate Court judges and will simplify the process for returning monies to heirs.

Other sections of the revised statute clarify the role of asset locators and require them to be bonded, providing increased consumer safety. An asset locator or heir finder is an individual or firm that charges a fee for locating an owner of unclaimed property or their heirs. Often the heir finder identifies abandoned or unclaimed property, locates the rightful owner or heir, and then wants to sign an agreement for a percentage of the property returned to owner. Asset locators are now required to register with the Treasurer's Office before they can contract with the owners to assist with location of abandoned property in our state. The new Act continues the existing Vermont law limiting the amount of fees that may be charged to 10%, and increases the period that contracts are unenforceable from the current 18 months after the property is abandoned to the 24 months recommended by the ULC. In addition, asset locators are required to post a

Unclaimed Property Division (continued)

Chart #27



$10,000 bond when they register with this office.

We continued our efforts to increase compliance with the law by holders that to date have not remitted property to this division. It is unfair both to the rightful owners and to the businesses that do comply when some entities do not remit these funds over to the Unclaimed Property Division We have held numerous education sessions over the last two years with a variety of groups, including the Vermont CPA Society and the Green Mountain Payroll Association. We appreciate these groups providing us the opportunity to reach their memberships. In addition, we have held education seminars for specialized industries, such as banking, insurance, and education institutions.

We have also expanded our program of voluntary compliance. A holder who was previously not in compliance but wishes to comply can complete a Voluntary Compliance Agreement and initiate a series of steps to come into compliance and, in turn, be released from any interest or penalties that would have accrued. This incentive to voluntarily comply has been quite successful, with 18 holders signing agreements with the Unclaimed Property Division. We have had an additional seven come forward; they are in the initial steps of signing that agreement. As a result of this and other holder outreach activities, we have added 1,260 new holders to the system.

While we will continue the education and voluntary compliance components of our program, the enforcement side of the program was also enhanced over the past year. The statute change enacted into law also included tougher penalties for non-compliance. We recently issued an RFP to secure the services of firms to complete in-state audits of companies for the purpose of identifying unreported unclaimed property.

Technology Services

The Technology Services Division is committed to provide programming and technical support services to the Office of the State Treasurer for the purposes of enhancing efficiency, accuracy, and security, and to contribute to the Office's commitment to a high standard of service to the State of Vermont, its clients, and its citizens. This Technology Division provides support to the entire range of software supporting the operations of the Treasurer's Office, including bank reconciliation software, check and EFT issuance, unclaimed property, and the various programs supporting the retirement services for the State's approximately 43,000 active, vested, and retired members.

Technology staff accomplished several important upgrades to the network in 2006, including MS SQL Server 2005, Reporting Services under Dot Net, and the latest version of WSUS update server. Virtualization of servers using VMWare allows running many "virtual" servers on a single hardware server, reducing cost, space, power consumption, and heat, and enhancing the ability to recover from an outage or moving to an emergency site.

Working closely with DII, the Office of the State Treasurer has incorporated new advances in network security, including virtual firewalls (FWSM), and increased security features for its e-mail and public Web sites.

The retirement re-engineering project, now called VPAS (Vermont Pension and Administration System), began its implementation phase early in 2006. The backfile of 2 million electronic images, created in 2005, was successfully loaded into the Stellent imaging system that the fully integrated VPAS system will use. Until then the office has the benefit of the new imaging system on a stand-alone basis. Mass loads are now made to the system electronically, reducing the burden on the scanning staff. Technology Services has provided network and programming support to this project, as it will throughout the implementation phase.

Over the past year, the Technology Division has worked closely with various Treasury operations staff to enhance existing services, such as the Web-based reporting for municipalities and school systems which is used to remit and report employee and employer retirement contributions. This has greatly reduced paper and manual reconciliation processes, freeing staff to better meet the needs of the customer. Staff has also implemented many new projects, often in response to emergency situations. The platform used to receive data and to make emergency payments to dairy farmers was largely developed and implemented by our technology staff.

Over the past year we have implemented a business continuity and disaster recovery project. Business continuity planning is the mitigation planning for business disruption including, but not limited to, the categories of natural disasters; hardware and communications failures; internal or external sabotage or acts of terrorism; and similar disruptions or failures of certain business partners. As a result, guidelines and protocols for communication with our primary business partners (Department of Information & Innovation, Finance and Management, Human Resources) as

Technology Services (continued)

well as our customers, including state agencies, retirees, state employees, and citizens, and external supports (banks, investment managers, deferred comp and defined contribution vendors) are now in place. Technology staff have played a key role in developing the infrastructure supports to this plan.

All of the behind-the-scene, and many times under-appreciated, activities performed by this team form the foundation from which other Treasury employees can do their jobs – counsel an employee considering retirement, pay our 10,000 retirees, re-unite a citizen with his or her lost property, or invest billions of dollars of the State's operating and pension funds. The IT team's dedication, commitment, and drive for excellence give the Treasurer's Office staff the opportunity to make a positive difference for Vermonters.

From left to right: Paul Brodie (Re-engineering Project Staff), Lane Safford, Dan Fine, David Pruden, and Marge Sweeney (Re-engineering Project Manager).

Policy and Legal Research

Over the past year the Department's Director of Policy and Legal Research, William Rice, has been working with various departments on a variety of legal matters to improve operations within the State Treasurer's Office. Many enhancements have been made to the procurement and contracting process, as well as clarification of various statutes as they relate to retirement and unclaimed property. Over the past year, key legislation was enacted that will benefit Vermonters. These are summarized below.

2006 Legislative Highlights

Unclaimed Property

Vermont has regulated the disposition of abandoned property since at least 1843. Vermont's pre-existing unclaimed property law had been based on a combination of the 1954 and 1981 Uniform Unclaimed Property Acts, which were drafted by the National Conference of Commissioners on Uniform State Laws. The ULC has since redrafted the model law and in 1995 issued the Uniform Unclaimed Property Act (1995). This past session, the Vermont Legislature passed Act 161, largely based upon the 1995 Model Act. Act 161, which contains a number of improvements over previous law, including:

- A more flexible approach to notifying the public of the identities of unclaimed property owners.
- Owners will receive any income or gain realized on property that is not money until the time of sale. This means that owners of stock, for example, would be entitled to dividends and splits up to the time that the Treasurer liquidates the shares and turns them into cash.
- The Treasurer will have greater flexibility in the sale of property. This will allow the Treasurer's Office to maximize the profit on a sale of abandoned property.
- A new and unique program which after 10 years will end the right of owners to make claims for property valued at $100 or less. That money will be used for scholarships by the Higher Education Endowment Trust Fund.
- The Treasurer now has improved enforcement capabilities.
- Individuals, known as asset finders, are now required to register with the Treasurer's Office before they can contract with the owners to assist with location of abandoned property.
- The new Act continues current Vermont law limiting the amount of fees that asset finders to can charge to 10%, and increases the period that contracts are unenforceable from the current 18 months after the property is abandoned to the 24 months recommended by the ULC.
- Finally, the new Act will maintain the unique Vermont rule that exempts heirs from having to reopen probate court proceedings in order to collect unclaimed assets of less than $2,500, which is an increase over the current $1,000 exemption.

Retirement

The Legislature enacted several different bills during the 2006 session amending existing retirement laws.

Policy and Legal Research (continued)

Highlights of those changes include, by retirement system:

Legislation Affecting the State Employees' Retirement System

Act No. 163 – Minimum pension increase for Group A retirees, expansion of Vietnam period for military credit, and new dental plan.

- The minimum pension for Group A retirees with 30 or more years of service has increased to $6,600 effective September 1, 2006. Group A retirees who retired with less than 30 years of service will receive a pro-rated increase in their retirement benefits. The Act includes an automatic $1,000 increase in the minimum pension every five years.

- The period of Vietnam service recognized for either a grant of service or a stipend has been expanded to include the dates between February 28, 1961, through August 4, 1964, if service was performed in what is now the Republic of Vietnam.

- The State Treasurer's Office is now authorized to establish a dental plan for State retirees to be effective January 1, 2007. All existing retirees will have a one-time option to join, and all new retirees on or after January 1, 2007 may enroll at the time of retirement. The cost of the premiums will be borne solely by the retiree, with no portion paid by the system.

Act No. 165 – Comprehensive Act for the State System

- Act 165 allows a group C member to retire under normal retirement with 30 years of service at any age.

- It provides members retiring on or after January 1, 2007, with a new option. After January 1st, if a member elects a survivorship option to protect the retirement income for a dependent beneficiary, he or she may also elect to receive a reduced percentage of the medical premium in order to allow that same percentage to continue to the dependent beneficiary for the remainder of their lifetime.

- The Act grants law enforcement employees in the group F plan a one-time option on or after January 1, 2007, to transfer to the group C plan effective July 1, 2007.

- It created a study committee to:

    - study options for providing existing and future state employees with the opportunity to recapture medical insurance and medical benefits for new hires;

    - study criteria for membership, plan structure, and contribution rates of the group C plan;

    - evaluate the appropriate retirement group plan for state's attorneys and the attorney general;

    - conduct a survey of members of the group F plan relating to post-retirement cost of living adjustments;

    - consult with the membership of all groups affected by the issues within the scope of the study.

Policy and Legal Research (continued)

Act No. 151 – Option for DC members who become judges

This Act allows exempt state employees who had previously elected to participate in the defined contribution (DC) plan the option to elect to transfer back to the defined benefit (DB) plan if they later become appointed as a judge. The Act mandates that if the newly-appointed judge elects to transfer back to the DB plan, he or she must transfer the entire account balance in the DC plan back to the DB plan.

Act No. 150 – Coordination of disability retirement benefits with workers' compensation.

Act 150 allows an employee who has been denied a workers' compensation claim to appeal the denial while drawing a disability retirement benefit, if the employee is eligible for those benefits. If the denial is reversed and retroactive workers' compensation benefits are granted, the retirement system will be reimbursed for the disability benefits paid during the interim. The Act also requires a disabled employee who is eligible for both a disability retirement and an award for a permanent partial or total disability from workers' compensation that is expected to extend beyond 330 weeks to make an election at the time of commencement of benefits. The disabled employee must elect whether to continue to receive the retirement or workers' compensation award beyond 330 weeks.

Legislation affecting the Municipal Employees' Retirement System

The following provisions are contained in Act No. 197:

- Act 197 clarifies how the average final compensation (AFC) will be calculated for members who separate from service within a fiscal year. The language mirrors the current practice for calculating AFC.

- expands the definition of "employee" within a school district to include employees who work 24 or more hours per week for the full year, and eliminates the reference to museum employees, as it is no longer applicable.

- The legislation amends the definition of "employer" to be consistent with the definition of "employee" for libraries, and removes museums from the definition, as it is no longer applicable.

- It adds to current law a provision that allows a member who is purchasing creditable service to spread the payments over three equal annual installments in lieu of a single, lump-sum payment.

- The Act amends the disability provisions: to require that applications must be filed within 90 days of separation from service, changes the eligibility requirements and the effective date of the benefit, creates language consistent with current practice relating to the medical review board process, and provides for an automatic approval if already approved by the Social Security Administration.

- It allows the retirement system or a disability applicant to appeal a decision of the hearing officer for approval or denial of a disability benefit.

Policy and Legal Research (continued)

- The new law tightens up language allowing an annual review after a disability benefit has been granted.

- It adds language that would allow a non-dependent designated beneficiary to receive a return of contributions and interest upon the death of an active member of the system.

- The legislation clarifies when cost-of-living adjustments will be applied to retiree pensions.

- The Act provides the authority for a municipality's legislative body to offer the group D plan without having to put it to a vote at an annual or special meeting of the municipality.

- And, it creates language to allow the Board of Trustees to establish a type of health reimbursement account that can be accessed by retired members.

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Legislation affecting the Teachers' Retirement System

Act No. 104 – Restoration of prior service

Act 104 allows members who had a prior membership that has been withdrawn to restore the service credit from the prior membership by re-depositing their own contributions with interest back into the system, along with an amount that would equal what the employer would have contributed with interest from date of withdrawal to date of restoration. The interest rate that will be charged on the previous employee and employer contributions is equal to the assumed interest rate adopted for the Teachers' Retirement System, currently 8%.

Act No. 163 – Minimum pension increase for Group A retirees and expansion of Vietnam period for military credit

The minimum pension for Group A retirees with 30 or more years of service increases to $9,000. Group A retirees who retired with less than 30 years of service will receive a pro-rated increase (inquiries may affect our ability to complete the calculations by the September deadline). In addition, the period of Vietnam service recognized for either a grant of service or a stipend will be expanded to include the dates between February 28, 1961, through August 4, 1964, if service was performed in what is now the Republic of Vietnam.

Act No. 165 – New medical insurance option for future retirees

Members retiring on or after January 1, 2007 will have a new option.
Beginning on that date, if a member elects a survivorship option to protect the retirement income for a dependent beneficiary, he or she may also elect to receive a reduced percentage of their medical premium in order to allow that same percentage to continue to their dependent beneficiary for the remainder of their lifetime.

Legislative Reporting Requirements

Brandon Training School

Section 23 of Act 62 of the Public Acts of 1995 specifies that the State Treasurer shall notify the chairs of the Senate and House Institutions committees upon receipt of monies from the sale of the Brandon Training School property, as well as certain federal receipts associated with the Vermont Veterans' Home. For fiscal year ending June 30, 2006, the State has timely received amounts due from the federal government associated with the Vermont Veterans' Home. There were no sales of property belonging to the Brandon Training School in FY2006.

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. Notifications from external investment managers listing such businesses are due in the Treasurer's Office on January 1 of each year, and these notifications are kept on file in the Treasurer's Office. The Act further requires that the Treasurer and the boards of the trustees of the Vermont State Employees' Retirement System and the Vermont State Teachers' Retirement System shall support the MacBride Principles worker equality and security issues through support of shareholder issues. The Treasurer's Office and the trustees comply with Act 50 by mandating MacBride Principles compliance through Vermont Pension Investment Committee (VPIC) investment guidelines to be observed by investment managers. Proxy voting guidelines approved by the three Vermont Retirement Systems and the Treasurer's Office for US domestic equity managers also specify manager voting compliance with MacBride principles.

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 VPIC investment guidelines that must be observed by investment managers. Proxy voting guidelines adopted by the three Vermont Retirement Systems and the Treasurer's Office for US domestic equity managers also specify manager voting compliance including support of labor standards in connection with a company's involvement in Burma, and reporting on Burmese operations and activities.

Survivors of Emergency Personnel

Act No.33 passed during the 2005 legislative session changed the name of the Firefighters' Survivor Benefit Fund to the Survivors of Emergency Personnel Benefit Fund. Originally established by the Legislature in 2002, the fund has been expanded to include ambulance service, emergency medical, first responder service and volunteer personnel. A review Board

Legislative Reporting Requirements (continued)

administers the grant of a one-time monetary benefit to the survivor or survivors of emergency personnel employed by or who volunteer for the state of Vermont, a county or municipality of the state, or a nonprofit entity which provides services in the state, who die in the line of duty or of an occupational related illness. The board met once during the year. Thankfully, no benefit awards were required to be paid out to survivors this past year. At November 30, 2006, the fund has assets of $223,176. The governor is requesting an additional $50,000 of funding in the current budget process.

Credit Card Payments

This past year, our office continued to work with departments to facilitate acceptance of credit cards; whether the card is present, over the telephone, over the internet or through the mail. The Treasurer's Office contracts with TDBanknorth Merchant Services, a division of TDBanknorth, to provide credit and bank card services. Acceptance of credit and debit card payments is widely practiced in many agencies and departments as a method of payment of registration fees, licenses, penalties, fines, durable goods, park reservations, interest, and payment of taxes. Our customers, the citizens of Vermont, should be provided with more convenient ways to deal with government. In addition to public convenience, electronic processing of consumer and business purchases improves governmental cash flows, offers greater financial security, and reduces the overhead costs associated with the handling of currency.

The Court Administrator's Office has been working with the Treasurer's Office and the Vermont Information Consortium (VIC) to develop a Web portal to accept credit card payments. VIC is the official contractor to the State of Vermont, Department of Information and Innovation, for this purpose. The process will be used initially by Judicial branch employees to accept credit card payments at service counters, the Judicial Bureau, and Chittenden District Court beginning in December of 2006. The Bureau is revising forms to include a credit card payment option which should be distributed in January of 2007. The Court Administrator's Office is planning to launch an online payment option in late spring.

CREDIT CARD ACCOUNTS	SALES	FEES
VT Dept. of Liquor Control	$13,796,680.75	$318,305.79
VT Dept. of Motor Vehicles	5,357,120.40	8,692.14
VT Dept. of Taxes	2,805,226.94	1,361.77
VT Dept. of Fish & Wildlife	551,323.64	10,496.81
VT Dept. of Forest, Parks & Recreation	2,119,907.13	43,993.37
VT Dept. of Health	162,635.62	3,704.13
Vermont Life Magazine	460,200.14	11,373.74
Vermont Judicial / Courts	0.00	480.00
Agency of Commerce & Community Development	5,765.00	922.62
Center for Crime Victims Services	108,202.64	1,697.86
Secretary of State	24,850.00	361.63
Environmental Conservation	252.50	167.50
Total	25,392,164.76	401,557.36

Appendices

A. Pension Fund Financial Statements for 2006

B. Historical Summary of Pension Fund Operations

C. Annual Report on the Higher Education Trust Fund

STATE OF VERMONT
PENSION TRUST FUNDS
COMBINING STATEMENTS OF PLAN NET ASSETS
6/30/2006

	Vermont State Retirement System	Vermont State Defined Contribution Plan	State Teachers' Retirement Fund	Single Deposit Investment Account	Vermont Municipal Employees' Retirement Fund	Vermont Municipal Employees' Defined Contribution Fund	Total Pension Trust Funds
Assets:							
Cash and short term investments	$ 172,077,234	$ 245,398	$ 169,779,659	$ 7,032,802	$ 40,914,456	$ 31,143	$ 390,080,692
Receivables:							
Contributions	2,915,609	124,460	2,471,231	-	2,000,611	4,620	7,516,531
Interest and dividends	5,898,537	-	6,257,780	1,721,292	1,882,178	-	15,759,787
Investments sold	25,155,845	-	27,419,575	-	5,663,762	-	58,239,182
Due from other funds	29,795	-	-	-	190,466	-	220,261
Other	-	-	554,058	-	10,487,456	-	11,041,514
Total receivables	33,999,786	124,460	36,702,644	1,721,292	20,224,473	4,620	92,777,275
Investments at Fair value:							
Fixed income	423,853,675	-	420,370,350	100,689,723	102,488,592	-	1,047,402,340
Equities	482,372,892	-	634,436,544	-	106,984,517	-	1,223,793,953
Real estate and venture capital	84,749,314	-	126,589,850	-	21,463,742	-	232,802,906
Mutual funds	126,299,286	35,285,003	144,342,041	-	28,066,508	10,499,319	344,492,157
Total investments	1,117,275,167	35,285,003	1,325,738,785	100,689,723	259,003,359	10,499,319	2,848,491,356
Prepaid expenses	1,157,691	20,922	1,032,663	-	-	-	2,211,276
Capital Assets:							
Construction in progress	87,864	-	100,722	-	25,716	-	214,302
Total capital assets	87,864	-	100,722	-	25,716	-	214,302
Total assets	**1,324,597,742**	**35,675,783**	**1,533,354,473**	**109,443,817**	**320,168,004**	**10,535,082**	**3,333,774,901**
Liabilities:							
Payable for investments purchased	103,917,882	-	101,251,290	15,862,514	26,627,983	-	247,659,669
Accounts payable	1,003,123	2,043	1,216,907	-	218,715	396	2,441,184
Accrued liabilities	42,191	-	43,793	-	17,258	-	103,242
Retainage payable	17,674	-	20,260		5,173	-	43,107
Due to other funds	-	29,795	-	-	-	190,466	220,261
Total liabilities	**104,980,870**	**31,838**	**102,532,250**	**15,862,514**	**26,869,129**	**190,862**	**250,467,463**
Net assets held in trust for employees' pension benefits	**$ 1,219,616,872**	**$ 35,643,945**	**$ 1,430,822,223**	**$ 93,581,303**	**$ 293,298,875**	**$ 10,344,220**	**$ 3,083,307,438**

STATE OF VERMONT
PENSION TRUST FUNDS
COMBINING STATEMENT OF CHANGES IN PLAN NET ASSETS
For the Fiscal Year Ended June 30, 2006

	Vermont State Retirement System	Vermont State Defined Contribution Plan	State Teachers' Retirement System	Single Deposit Investment Account	Vermont Municipal Employees' Retirement System	Vermont Municipal Employees' Defined Contribution Fund	Total Pension Funds
Additions :							
Contributions							
Employer	$ 36,866,451	$ 1,793,339	$ 24,446,282	$ -	$ 7,926,436	$ 510,349	$ 71,542,857
Plan member	14,561,467	623,988	21,884,140	-	8,744,718	510,412	46,324,725
Transfers from other pension trust funds	1,061,201	185,320	641,382	-	228,746	234,566	2,351,215
Transfers from non-state systems	110,315	-	-	-	-	-	110,315
Medicare part D drug subsidy	-	-	539,224	-	-	-	539,224
Total contributions	**52,599,434**	**2,602,647**	**47,511,028**	**0**	**16,899,900**	**1,255,327**	**120,868,336**
Investment Income:							
Net appreciation (depreciation) in fair value of investments	77,196,209	1,748,228	97,158,534	(4,583,335)	18,114,095	462,709	190,096,440
Dividends	13,609,537	1,217,918	16,058,318	-	4,891,118	343,519	36,120,410
Interest income	26,997,830	8,750	21,687,004	5,102,626	5,492,610	319	59,289,139
Securities lending income	564,411	-	509,138	-	119,963	-	1,193,512
Other income	852,694	-	613,637	44,787	52,076	4,907	1,568,101
Total investment income	**119,220,681**	**2,974,896**	**136,026,631**	**564,078**	**28,669,862**	**811,454**	**288,267,602**
Less Investment Expenses							
Investment managers and consultants	3,894,489	453	5,012,862	370,610	933,550	-	10,211,964
Securities lending expenses	179,777	-	178,184	-	38,941	-	396,902
Total investment expenses	**4,074,266**	**453**	**5,191,046**	**370,610**	**972,491**	**0**	**10,608,866**
Net investment income	**115,146,415**	**2,974,443**	**130,835,585**	**193,468**	**27,697,371**	**811,454**	**277,658,736**
Total additions	**167,745,849**	**5,577,090**	**178,346,613**	**193,468**	**44,597,271**	**2,066,781**	**398,527,072**
Deductions:							
Retirement benefits	53,435,617	2,621,556	66,272,471	7,529,287	7,120,325	582,621	137,561,877
Refunds of contributions	1,154,061	-	1,156,932	-	958,629	-	3,269,622
Death claims	197,850	-	133,265	-	144,311	-	475,426
Transfers to other pension trust funds	668,929	-	580,403	-	1,101,883	-	2,351,215
Operating expenses	12,919,669	270,309	12,913,737	-	439,983	37,378	26,581,076
Total deductions	**68,376,126**	**2,891,865**	**81,056,808**	**7,529,287**	**9,765,131**	**619,999**	**170,239,216**
Change in net assets	**99,369,723**	**2,685,225**	**97,289,805**	**(7,335,819)**	**34,832,140**	**1,446,782**	**228,287,856**
Net assets held in trust for employees' pension benefits:							
July 1	**1,120,247,149**	**32,958,720**	**1,333,532,418**	**100,917,122**	**258,466,735**	**8,897,438**	**2,855,019,582**
June 30	**$ 1,219,616,872**	**$ 35,643,945**	**$ 1,430,822,223**	**$ 93,581,303**	**$ 293,298,875**	**$ 10,344,220**	**$ 3,083,307,438**

State Employees' Retirement System
Summary of Operations

Category	2003	2004	2005	2006
SOURCES OF FUNDS				
Employee Contributions	$ 12,171,186	$ 13,716,264	$ 15,112,105	$ 14,561,467
Employer Contributions	24,394,933	26,645,619	36,493,435	36,866,451
Other Income	813,168	695,397	777,792	1,171,516
Investment Income	40,435,216	138,426,552	90,452,723	115,146,415
APPLICATION OF FUNDS				
Retirement Benefits	41,614,187	44,637,116	48,893,673	53,435,617
Refunds	923,964	1,171,957	1,402,481	1,351,911
Health/Life Insurance Expenses	9,916,398	9,236,526	11,329,269	11,590,588
Administrative Expenses	971,394	659,447	1,255,852	1,329,081
Other Expenses	369,383	617,658	635,618	668,929
Addition to Net Assets Held in Trust for Pension Benefits	$ 24,019,177	$ 123,161,128	$ 79,319,162	$ 99,369,723

Teachers' Retirement System
Summary of Operations

Category	2003	2004	2005	2006
SOURCES OF FUNDS				
Employee Contributions	$ 18,820,703	$ 21,088,345	$ 21,158,452	$ 21,884,140
Employer Contributions	20,446,282	24,446,282	24,446,282	24,446,282
Other Income	438,166	267,330	373,705	1,180,606
Investment Income	52,506,838	166,325,045	115,058,694	130,835,585
APPLICATION OF FUNDS				
Retirement Benefits	50,409,313	55,246,342	60,147,731	66,272,471
Refunds	1,109,174	711,806	1,104,278	1,290,197
Health/Life Insurance Expenses	6,634,738	8,279,332	10,167,601	11,233,854
Administrative Expenses	763,527	805,495	1,052,772	1,679,883
Other Expenses	702,568	543,746	682,438	580,403
Addition to Net Assets Held in Trust for Pension Benefits	$ 32,592,669	$ 146,540,281	$ 87,882,313	$ 97,289,805

Muncipal Retirement System
Summary of Operations

Category	2003	2004	2005	2006
SOURCES OF FUNDS				
Employee Contributions	$ 5,000,479	$ 6,507,268	$ 7,404,119	$ 8,744,718
Employer Contributions	5,707,184	7,114,813	8,058,810	7,926,436
Other Income	17,855,452	2,125,294	298,475	228,746
Investment Income	2,630,247	27,271,821	18,165,861	27,697,371
APPLICATION OF FUNDS				
Retirement Benefits	4,929,747	5,694,080	6,418,097	7,120,325
Refunds	639,170	1,110,243	1,140,245	1,102,940
Health/Life Insurance Expenses	-	-	-	-
Administrative Expenses	118,038	151,228	367,810	439,983
Other Expenses	546,692	668,624	423,937	1,101,883
Addition to Net Assets Held in Trust for Pension Benefits	$ 24,959,715	$ 35,395,021	$ 25,577,176	$ 34,832,140

TO: Commission on Higher Education Funding

FROM: Jeb Spaulding, State Treasurer

RE: Annual Report on the Higher Education Trust Fund

DATE: August 15, 2006

I am pleased to present the State Treasurer's seventh annual report on the Higher Education Trust Fund. This fund was established in the Office of the State Treasurer by the 1999 General Assembly (16 V.S.A. § 2885). Appropriations totaled $7,635,881.49 through 2002, $2,363,355.61 in 2005, and, as discussed further below, $5,823,449.94 in 2006. The statute 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 2005, the Higher Education Trust Fund dollar weighted return was 5.86%. This return compares to the Lehman Aggregate Bond Index return of 0.81% and to the S&P 500 Stock Index return of 8.63% for the same period, and exceeds the Fund's target rate (based on actual asset allocation and index returns) of 2.19%. The 5% distribution available this year is $469,095.23 in total, or $156,365.08 each for UVM, VSC, and VSAC; the distribution made following Fiscal Year 2005 was $140,552.61 for each institution. (See Appendix A for quarterly market values and distributions for fiscal year 2006.)

16 V.S.A. § 2885 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 average 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 total contributions to principal.

At its meeting last year, the Commission authorized this 2% appropriation in the amount of $168,663.14, or $84,331.57 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 is required to match the appropriation by raising twice that amount, or $168,663.14, 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. Each of these institutions is in the process of establishing the required certification.

After payments of $469,095.23 and $168,663.14, the balance in the fund at the beginning of fiscal year 2007 totals $10,550,941.39.

All principal contributions to June 30, 2006, total $9,999,237.10 (see Chart #1). This represents the current minimum balance that must be maintained in the fund. The 2% distribution proposed for this year of $187,638.09 would leave a balance of $10,363,303.30 excluding contributions received, 5% distribution, and any gains from investment activity in Fiscal Year 2007. If the committee authorizes this distribution, each institution's share will be $93,819.05 with a required match to be raised by each entity in Fiscal Year 2007 of $187,638.09. Chart #2 is a graphical depiction of distributions, including this 2% distribution subject to committee approval.

An accounting of the fund balances is provided below:

Ending balance FY 2005		$8,855,599.91
Contributions received FY 2006		2,363,355.61
Opening balance FY 2005		11,218,955.52
Distribution August 2005		(584,237.33)
Income earned fiscal year 2006		490,132.24
Appreciation (Depreciation) FY 2006		106,439.80
Fees and Other Charges FY 2006		(42,590.47)
Balance June 30, 2006		11,188,699.76
5% of 12-Quarter Moving Average June 30, 2006		(469,095.23)
Distributions: University of Vermont	(156,365.08)	
Vermont State Colleges	(156,365.08)	
Vermont Student Assistance Corp.	(156,365.08)	
2% Income Available for Endowments from FY 2005		(168,663.14)
Balance after distributions		10,550,941.39
Total contributions as of 6/30/2006		9,999,237.10
2% Income Available for Endowments from FY 2006 (requires institutional match in FY 2007)		$187,638.09

I have attached a spreadsheet as Appendix B that shows the total return of the entire Trust Investment Account, of which the Higher Education Trust Fund at $11,188,699.76 (prior to cash distributions to be made in fiscal year 2007) comprises approximately 23%. The Tobacco Trust Fund comprises 71% of the account, or $35,253,339.24, and the remaining 6% is made up of eight small unexpendable trusts that total $488,640.88, the ANR Stewardship Fund at $609,728.76, two Veterans' Home trusts totaling $1,027,586.57, and the Fish and Wildlife Trust Fund at $1,112,957.74. Chart #3 displays the relative share of the Higher Education Trust Fund compared to the entire fund. Chart #4 identifies the major asset classes in the portfolio and their performance over the past six years.

As noted in Chart #5, assets increased significantly due to receipt of funds raised by the Estate Tax ($2,363,355.61 derived from FY 2005 and received into the fund in FY 2006) as well as investment return. Fixed income continues to be the principal source of total return over the life of the Fund due to a combination of asset allocation and market forces. However, the Fund's equity investments have once again provided a significant contribution to the Fund's performance for the most recent fiscal year. The asset allocation of the Fund at June 30, 2006, comprised 32.5% equities and 67.5% fixed income securities versus 30.4% equities and 69.6% fixed income securities, respectively, at June 30, 2005. Currently, allocations of contributions and sources of distributions in the Trust Investment Account are used to target a 70% - 30% ratio in favor of fixed income securities. This balance addresses joint investment objectives of investment return and capital preservation.

The Higher Education Endowment Trust Fund Act provides that contributions shall include "… in any fiscal year in which a general fund surplus exists and the general fund stabilization reserve is funded to its required statutory level, funds raised by the estate tax under chapter 190 of Title 32 which are more than 125 percent of the amount projected by the emergency board in the July annual forecast made pursuant to section 305a of Title 32." This year a substantial contribution in the amount of $5,223,449.94 derives from fiscal year 2006, and this contribution became part of the Higher Education Trust Fund in July 2006. In addition, the Higher Education Trust Fund will receive another $600,000 from the State's Unclaimed Property Fund, as a result of legislation proposed by the State Treasurer and enacted into law this year. Under the new statute, all unclaimed property worth less than $100 under State custody for ten years or longer will be turned over to the Higher Education Trust Fund. Thus the Fund's investment base is significantly increased for fiscal year 2007, and depending upon investment market conditions can be expected to generate additional returns to the Fund.

In summary, while the investment performance of the Trust Investment Account once again far exceeded its target return, market conditions and a conservative asset allocation created a return below a level fully supporting this year's distributions. Going forward, distributions will depend on the ongoing performance of the Fund, and will require continued monitoring of the Fund's investment performance, as well as ongoing consideration of optimal asset allocation in evolving investment marketplaces.

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

cc: James Reardon, Commissioner of Finance & Management
Anne Winchester, Legislative Council

Appendix A
Higher Education Trust Fund
Quarterly Market Values

	Balance 9/30	Balance 12/31	Balance 3/31	Balance 6/30	
Education Trust					
FY2004	$8,242,399.79	$8,505,386.89	$8,697,470.84	$8,625,716.81	
FY2005	$8,241,108.63	$8,566,614.41	$8,617,473.66	$8,855,599.91	
FY 2006	$10,849,205.23	$10,921,067.11	$11,272,112.39	$11,188,699.76	
Twelve Quarter Average	**$9,381,904.62**				
5% Distribution 2006	**$469,095.23**				
VSAC		$156,365.08		Contributions	
UVM		$156,365.08			
VSC		$156,365.08		Initial	$6,000,000.00
				2001	$1,000,000.00
2% **FY2005**	**$168,663.14**			2002	$635,881.49
UVM		$84,331.57		2003	$0.00
VSC		$84,331.57		2004	$0.00
				2005	$2,363,355.61
Balance after Distributions	**$10,550,941.39**				
				Total	**$9,999,237.10**
2% FY2006	$187,638.09				
UVM		$93,819.05			
VSC		$93,819.05			

Appendix B
Trust Investment Account
Total Return Analysis

MANAGER	Fiscal Year 2001	Calendar Year 2001	Fiscal Year 2002	Calendar Year 2002	Fiscal Year 2003	Calendar Year 2003	Fiscal Year 2004	Calendar Year 2004	Fiscal Year 2005
DOMESTIC EQUITY									
Hanson Investment Management	**29.41%**	**17.41**	**(7.78)**	**(18.01)**	**-1.89%**	**42.55%**	**29.10%**	**15.92%**	**22.25%**
Prentiss Smith & Co.	**7.59%**	**13.69**	**3.60**	**(7.35)**	**7.70%**	**18.17%**	**11.47%**	**13.25%**	**11.00%**
S&P 500	***-13.56%***	***-11.89%***	***-17.99%***	***-22.11%***	***0.25%***	***28.69%***	***19.14%***	***10.90%***	***6.32%***
DOMESTIC FIXED INCOME									
NL Capital Management	**10.34%**	**10.07%**	**9.41%**	**9.48%**	**8.92%**	**5.43%**	**3.48%**	**5.56%**	**7.42%**
Lehman Aggregate	***10.23%***	***8.44%***	***8.63%***	***10.25%***	***10.40%***	***4.10%***	***0.32%***	***4.34%***	***6.80%***
TOTAL FUND DOLLAR WEIGHTED RETURN	**11.27%**	**11.62**	**7.94**	**5.15**	**8.59%**	**11.24%**	**7.59%**	**8.14%**	**10.17%**
Total Fund Target	**7.52%**	**6.57**	**3.12**	**3.29**	**9.23%**	**9.94%**	**4.96%**	**6.23%**	**6.76%**
TOTAL FUND MARKET VALUE ($mil)	**$26.5**	**$32.6**	**$33.3**	**$34.9**	**$37.3**	**$38.8**	**$39.3**	**$41.1**	**$43.5**

MANAGER	Quarter Ended 9/30/2005	Quarter Ended 12/31/2005	**Calendar Year 2005**	Quarter Ended 3/31/2006	Quarter Ended 6/30/2006	**Fiscal Year 2006**	Portfolio Market 6/30/2006	Portfolio Percent 6/30/2006
DOMESTIC EQUITY								
Hanson Investment Management	8.40%	2.26%	**19.18%**	13.33%	-3.60%	**21.10%**	$8,781,896	17.7%
Prentiss Smith & Co.	7.92%	0.86%	**10.68%**	6.40%	-0.10%	**15.77%**	$7,369,828	14.8%
S&P 500	*3.60%*	*2.09%*	***4.91%***	*4.21%*	*-1.44%*	***8.63%***		*32.5%*
DOMESTIC FIXED INCOME								
NL Capital Management	-0.50%	0.44%	**3.07%**	0.16%	0.17%	**0.26%**	$33,529,229	67.5%
Lehman Aggregate	*-0.67%*	*0.59%*	***2.43%***	*-0.65%*	*0.08%*	***-0.81%***		
TOTAL FUND DOLLAR WEIGHTED RETURN	2.15%	0.80%	**6.64%**	3.37%	-0.55%	**5.86%**		
Total Fund Target	0.64%	1.05%	**3.27%**	0.91%	-0.42%	**2.19%**		
TOTAL FUND MARKET VALUE ($mil)	**$48.3**	**$48.6**	**$48.6**	**$50.1**	**$49.7**	**$49.7**	$49,680,953	**100.0%**

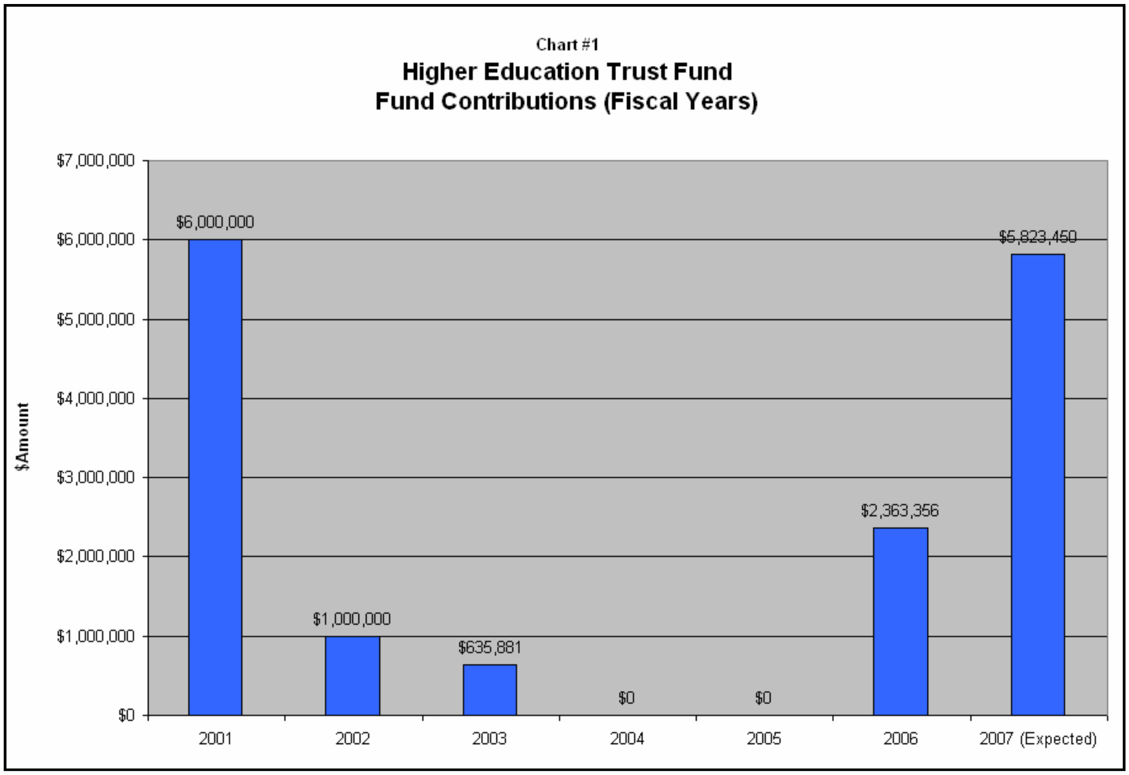
Chart #1
Higher Education Trust Fund
Fund Contributions (Fiscal Years)
$Amount
$7,000,000
$6,000,000
$5,000,000
$4,000,000
$3,000,000
$2,000,000
$1,000,000
$0
$6,000,000
$1,000,000
$635,881
$0
$0
$2,363,356
$5,823,450
2001
2002
2003
2004
2005
2006
2007 (Expected)

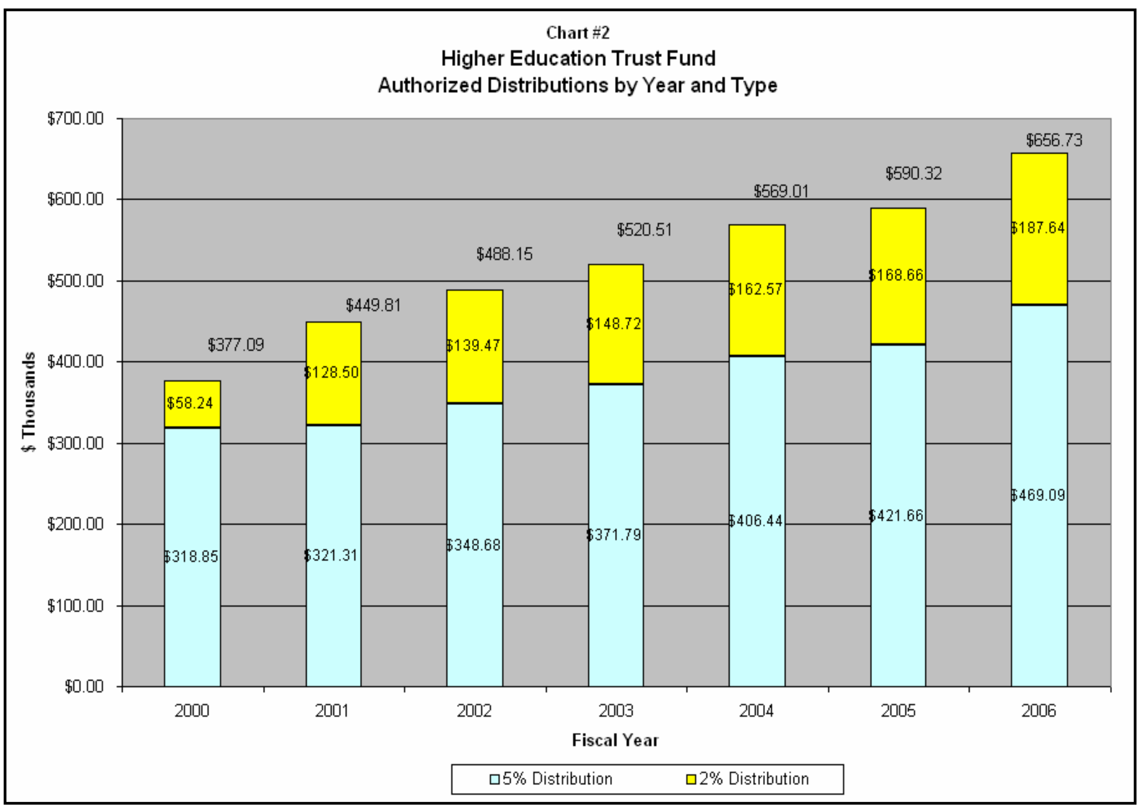
Chart #2
Higher Education Trust Fund
Authorized Distributions by Year and Type
$ Thousands
$700.00
$600.00
$500.00
$400.00
$300.00
$200.00
$100.00
$0.00
$377.09
$58.24
$318.85
$449.81
$128.50
$321.31
$488.15
$139.47
$348.68
$520.51
$148.72
$371.79
$569.01
$162.57
$406.44
$590.32
$168.66
$421.66
$656.73
$187.64
$469.09
2000
2001
2002
2003
2004
2005
2006
Fiscal Year
5% Distribution
2% Distribution

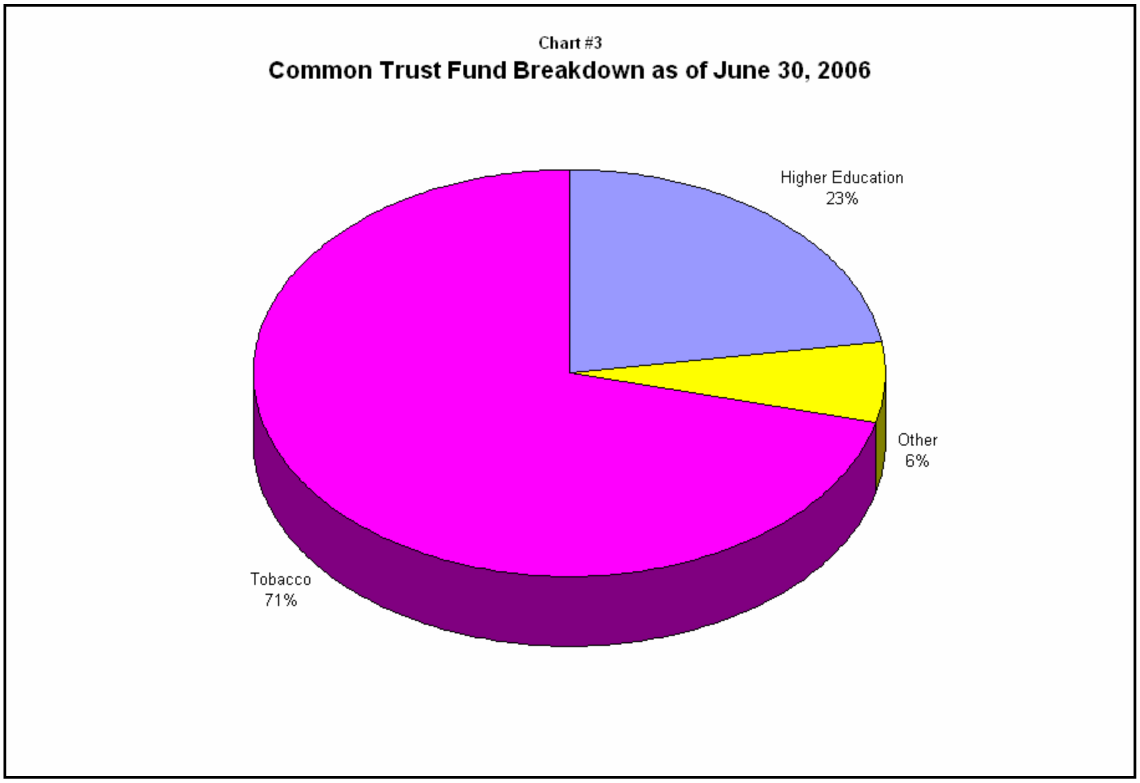
Chart #3
Common Trust Fund Breakdown as of June 30, 2006
Higher Education 23%
Other 6%
Tobacco 71%

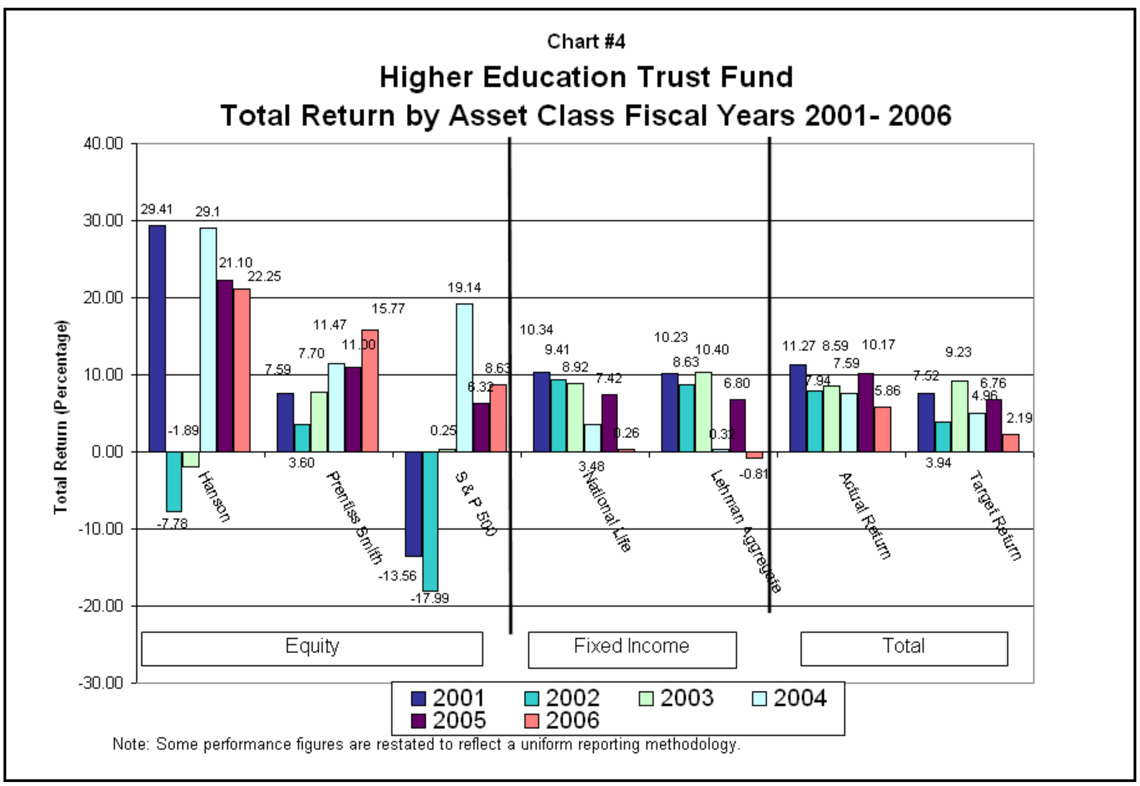
Chart #4
Higher Education Trust Fund
Total Return by Asset Class Fiscal Years 2001- 2006
Total Return (Percentage)
40.00
30.00
20.00
10.00
0.00
-10.00
-20.00
-30.00
29.41
-7.78
-1.89
29.1
21.10
22.25
Hanson
7.59
3.60
7.70
11.47
11.00
15.77
Prentiss Smith
-13.56
-17.99
0.25
19.14
6.32
8.63
S & P 500
10.34
9.41
8.92
3.48
7.42
0.26
National Life
10.23
8.63
10.40
0.32
6.80
-0.81
Lehman Aggregate
11.27
7.94
8.59
7.59
10.17
5.86
Actual Return
7.52
3.94
9.23
4.96
6.76
2.19
Target Return
Equity
Fixed Income
Total
2001
2002
2003
2004
2005
2006
Note: Some performance figures are restated to reflect a uniform reporting methodology.

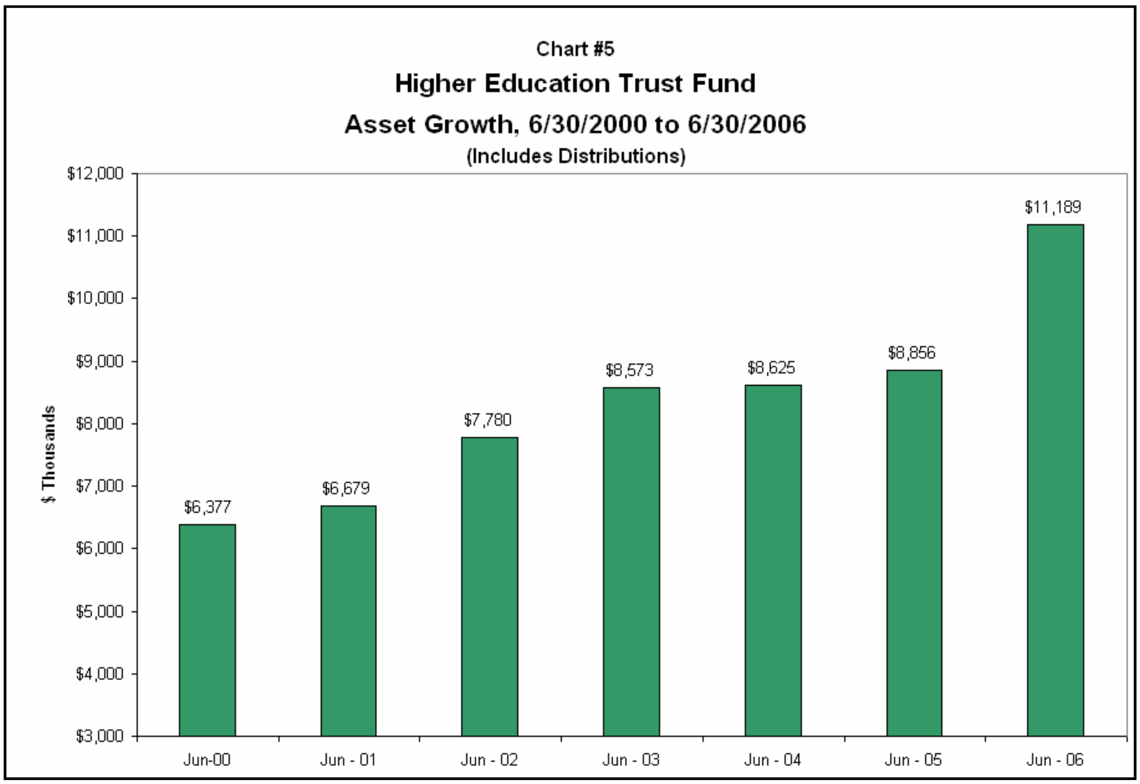
Chart #5
Higher Education Trust Fund
Asset Growth, 6/30/2000 to 6/30/2006
(Includes Distributions)
$ Thousands
$12,000
$11,000
$10,000
$9,000
$8,000
$7,000
$6,000
$5,000
$4,000
$3,000
$6,377
$6,679
$7,780
$8,573
$8,625
$8,856
$11,189
Jun-00
Jun - 01
Jun - 02
Jun - 03
Jun - 04
Jun - 05
Jun - 06

I just wanted to take a moment to thank you for your assistance in dispersing those old amounts of insurance money from our parents. You assistance and extra effort to make sure this was successfully completed is much appreciated by my family. You could have easily given up or let it slide. You are an excellent example of good people in public service that are dedicated to their job. I will pass my compliments on to your boss. Again, thank you and keep up the great work, Vermont is more friendly and efficient place for your efforts!

Thanks for the very useful information you sent me.
It is an enormous help to me as I decide what to do with my future.
It is always gratifying when a former student is doing well, both professionally and personally.

Thank you for your help. I look forward to your correspondence.

"Thank-you" so much for all your help. This is honestly an answer to prayer. Our one concern has been how we could retire as N.H. does not offer us an insurance benefit or prescription drug plan for retirement. We fall through the cracks (age & time in service). We have prayed for an answer - and this is it.

You made the process simple and we are very grateful.

May God Bless you in a special way for your kindness.

Just a note to say "merci" for your time and all the information you provided for me and my husband at our meeting.

Your professional competence as well as your pleasant manner in answering our questions about retirement helped to ease concerns we may have had about this major life decision. "Thank you" again.

Thank you so much for all your help with retirement for both me and my husband. We appreciate your patience and guidance through this "crazy" process! You went above and beyond when working with our broker

Unclaimed Property Technician
Thank you for all courtesies extended to me and to my sister-in-law, Marilyn

I am indebted to you good people at our Treasurer's Office for your acuity in spotting what is for me not an insignificant matter. Have you folks any idea of the high regard in which you are held by retired Vermont teachers? After so many years with kids and school boards, so many thousands of kids, most teachers greet retirement with some apprehension. The people surrounding you and you, yourself, make the retirement transition so utterly uncomplicated that most retired teachers consider you friends and your efforts on our behalf are resolutely appreciated. Somehow, you folks make the years of chalky fingers worthwhile.

Thanks for all your help. You made what seemed like an overwhelming process understandable and manageable

Thanks again for making my transition into "retirement" so easy!

THANKS TO YOU & ALL THAT WORKED YOUR HELP IS APPRECIATED. AGAIN, THANK YOU!

I just want to say: Thank you for your kindness and speedy service. I appreciate it very much.
Friendly greetings!

It is rare in this day and age to run into someone as efficient and courteous. She was able to help me sort through this complicated process and get the necessary paperwork started to finally settle this matter. I wanted you to know what a true asset she is to your office. If the rest of your staff is as talented and helpful then your job must be a pleasure. State agencies often get put down and my guess is that it is rare to get thanks in the job you do. I want to thank you for a job well done…it makes me want to move to Vermont!!! Once again, I hope you know what a jewel you have she is extraordinary and solved what was becoming an impossible problem for us.

THANK YOU FOR ALL YOUR HELP!