Introduction

December 15, 2013

Dear Members, Retirees and Beneficiaries:

On behalf of the Board of Trustees, we are pleased to present the Comprehensive Annual Financial Report of the Maryland State Retirement and Pension System for the fiscal year ended June 30, 2013. This report provides information on the financial status of the retirement system and highlights important events that occurred during a period when the system issued monthly, on average, about $249 million in payments to nearly 138,000 retirees and beneficiaries.

Fiscal Year 2013 was a very strong year for investment returns as the system’s portfolio returned 10.57%. This return exceeded both the actuarial return assumption for the fiscal year of 7.75% and the policy benchmark of 8.48% by significant margins. The policy benchmark can be thought of as the passive alternative to the system’s asset allocation. Active management added value to the fund in the fiscal year, as well as over longer time periods. All of the system’s asset classes experienced positive returns in the fiscal year, with the exception of the Real Return asset class, which struggled as inflation-sensitive assets were not in high demand by investors since inflation has been benign.

While we are pleased with the investment performance of the fund in fiscal year 2013, the board continues to focus on long-term performance. The capital markets are always going to experience volatility, which will result in good years and bad years. Being a long-term investor allows the system to weather some short-term volatility for long-term returns. Over the last 25 years—a period that has included two recessions, most notably the Great Recession—the system has earned an average return of 7.82%.

During its 2013 session, the General Assembly enacted legislation which will phase out the so-called “corridor funding” methodology, which the board has consistently opposed since it was enacted in 2002. This method of funding has been a significant contributor to the system’s chronic underfunding over the last decade. The 2013 legislation will phase out use of the corridor method over the next ten years and return funding to the actuarially required contribution methodology. Following the pension reform measures passed during the 2011 General Assembly session, the board recognizes this funding change as another key ingredient that will lead the system to full funding by 2039.

In another significant move, the board decided to lower the system’s assumed rate of return from 7.75% incrementally over the next four years to 7.55%. The board made the change in order to more accurately reflect the pension fund’s expected long-term future investment gains. The decision was made following careful analysis, with significant input from the system’s actuary and investment consultant. The assumed rate of return will be lowered 0.05% each fiscal year beginning with the July 2013 actuarial valuation.

The board’s fundamental mission is to ensure that retirement benefits are paid in full, and in an accurate and timely manner. The board oversees the investment of the Maryland State Retirement and Pension System assets in order to help ensure the funding necessary to meet those obligations.

Your retirement system remains administratively and financially sound. As a participant in the system, you can remain confident that your pension benefits are secure. As always, your commitment to and involvement in the concerns of the system are greatly appreciated. We value your input—this is your system. If you have any questions, please do not hesitate to contact us.

Sincerely,

NANCY K. KOPP
Chairman

PETER FRANCHOT
Vice Chairman
Introduction

LETTER OF TRANSMITTAL

December 15, 2013

Honorable Chairman and Members of the Board of Trustees:

We are pleased to submit the Comprehensive Annual Financial Report for the Maryland State Retirement and Pension System for the fiscal year ended June 30, 2013. We believe this report fairly presents the operating results achieved during this 12-month reporting period.

The system is responsible for properly administering retirement, disability, and death benefits. At the same time, it strives to keep employer contribution rates as reasonable as possible by maximizing investment returns while maintaining an acceptable level of risk. Members covered by the plans include state employees, teachers, law enforcement officers, legislators, judges, as well as local government employees, law enforcement officers, and correctional personnel whose employers have elected to participate in the system.

The system currently provides monthly allowances to about 138,000 retirees and beneficiaries, and is an essential element of the future financial security for more than 192,000 active participating members. Descriptions of the membership requirements and benefits provided by each plan administered by the system are included in the Plan Summary Section starting on page 108.

This Comprehensive Annual Financial Report contains six sections. The Introductory Section provides information about the administrative structure of the system. The Financial Section provides a comprehensive review of the system’s financial position, the results of its operations and its funded status. The Financial Section also contains the report from the system’s independent auditor, the combined financial statements and supplementary financial data. The Investment Section includes a report highlighting the system’s investment performance in addition to various summary level portfolio compositions and other investment data. The Actuarial Section contains the independent actuary’s report on the results of the system’s annual actuarial valuation. The Statistical and Plan Summary Sections provide demographic composition of the system’s membership segments affected by each plan and detailed descriptions of the various plans’ provisions. In addition to this Letter of Transmittal, additional narrative, overview, and analysis can be found in Management’s Discussion and Analysis beginning on page 18.

INVESTMENTS

The system’s investment portfolio returned 10.57 percent in fiscal year 2013. The fund achieved its 7.75% actuarial return target for the fiscal year, and also exceeded the plan policy benchmark of 8.48 percent by 209 basis points.

The plan policy benchmark is a point of reference that compares the system’s total investment performance against the weighted average of the benchmark performance of each of the system’s underlying asset classes. Most of the system’s asset classes produced positive returns for the year, with the exception of the real return asset class, which was negatively impacted by inflation-sensitive securities in commodities and inflation-linked global bonds.

After the payment of benefits, the market value of assets increased by approximately $3.2 billion from $37.2 billion on June 30, 2012 to $40.4 billion on June 30, 2013.

The system’s target asset allocation is comprised of 35% public equities, 10% fixed income, 10% private equities, 10% credit/debt strategies, 10% real estate, 14% real return, 10% absolute return and 1% cash. The system’s portfolio is balanced across several asset and sub-asset classes and is globally diversified. This, coupled with a long term investment horizon, allows the system to weather short term market volatility.
**Major Issues**

With the strong support and encouragement of the board, the General Assembly passed legislation during the 2013 session that will phase the system out of the so-called “corridor funding” methodology—a contributing factor to its underfunding—over the next ten years and return the system to the actuarially required contribution (ARC) methodology. In addition, the system’s unfunded liabilities were reamortized to a 25-year closed schedule beginning with the June 30, 2013 valuation. This important funding change closely followed action taken during the 2011 session by Governor Martin O’Malley and the Maryland General Assembly to enact comprehensive pension reform that promises to lead the system to full funding by 2039.

Under the corridor funding method, contribution rates are fixed from year to year as long as the funded status for each of these systems remains in a “corridor” of 90% to 110%. When it was adopted in 2002, both systems were within the corridor, but within three years, the employees’ plan dropped out of the corridor and the teachers’ plan followed in 2006.

Since its enactment, the corridor funding method has resulted in annual reductions of between $100 million and $200 million in the state’s employer contributions, and thus contributed to the declining funded ratio for the Maryland State Retirement and Pension System because it creates deliberate short-term underfunding of the system’s liabilities. The board has been on record in opposition to this methodology since its implementation.

In the latter part of fiscal year 2013, the board decided to lower the agency’s assumed rate of return to 7.55% incrementally over the next four years to best reflect the pension fund’s currently expected long-term future investment gains. The decision was made following careful analysis by the board, with extensive analysis and significant input from the system’s actuary and investment consultant. Currently set at 7.75%, the assumed rate of return will be lowered 0.05% each fiscal year beginning with the July 2013 actuarial valuation. The 7.75% rate has been in effect since 2003.

With the leadership and oversight of the system’s Chief Investment Officer, implementation of the long-term asset allocation adopted by the Board of Trustees continues to proceed successfully. Consequently, system investments in alternative assets have steadily increased. Further information regarding the system’s investment program can be found in the Chief Investment Officer’s letter located in the Investment Section of this report.

**Financial Information**

System management has committed the resources necessary to maintain an internal control structure that provides reasonable assurance that assets are adequately safeguarded, financial records are consistently and accurately maintained, and transactions are properly executed to permit preparation of financial statements in accordance with generally accepted accounting principles. The system’s internal control structure includes written policies and procedures and an internal audit division that reports to the board.

**Accounting System and Reports**

The system reports its transactions on the accrual basis of accounting. Under this method, revenues are reported in the accounting period they are earned and become measurable, and expenses are reported when the related liability is incurred and measurable. Investments are reported at fair value at fiscal year end. Investment purchases and sales are reported in the accounting period in which the related trade dates occur.

**Revenues**

The reserves necessary to finance retirement allowances and other benefits are accumulated through investment earnings and the collection of employer and member contributions. During fiscal year 2013, investment earnings were $3.85 billion, while revenues from employer and member contributions were $1.64 billion and $710.9 million, respectively. For fiscal year 2013, member contribution rates on average were 7%, while employer rates varied depending on the system.

**Expenses**

The system’s expenses consist of monthly retirement allowances, refunds of contributions to terminated and transferring members and withdrawing employers, and the administrative cost of system operations. Payments to retirees, beneficiaries and transferring or withdrawing members and employers continued to be the system’s primary disbursements during FY 2013, totaling $2.9 billion. In addition, the system disbursed $311.1 million to manage the investment portfolio and to administer the system, of which $273.8 million was paid for investment management services, $5 million for securities lending services and $26.3 million used to fund the system’s administrative operations.

**Funding**

Funds are derived from the excess of additions, which include contributions and investment earnings, over deductions, which are comprised of benefits and administrative expenses. Funds are accumulated to meet future benefit obligations to retirees and beneficiaries. This accumulated balance is referred to as the “net assets held in trust for pension benefits” in the Statement of Pension Net Assets in the Financial Section of this report. The actuarial accrued liability is not disclosed in the basic financial statement but is disclosed in note nine to the basic financial statements. The funded status schedule presented in note nine shows the actuarial value of assets, which is based on a five-year smoothed expected rate of return, wherein the excess...
or shortfall of investment income over or under the actuarial assumed income of 7.70% is recognized over a five-year period. This is the value of assets used by the actuary in determining contribution rates for the systems as disclosed in note five to the basic financial statements.

The actuarial accrued liability of the systems is also determined by the actuary. It is a measure of the present value of actuarial accrued liabilities estimated to be payable in the future to current retirees, beneficiaries and employees for service earned to date. The percentage computed by dividing the actuarial value of net assets available for benefits by the actuarial accrued liability is generally referred to as the “funded ratio.” This ratio provides an indication of the funded status of the system on a going-concern basis and generally, the greater this percentage, the stronger the system. The system’s funded ratio increased from 64.4% as of June 30, 2012 to 65.5% as of June 30, 2013.

At June 30, 2013, the system’s actuarial accrued liability was $60.0 billion and the unfunded actuarial accrued liability totaled $20.7 billion, resulting in a funded status ratio of 65.5%. The unfunded actuarial accrued liability will be amortized over a closed 25-year period.

Professional Services

The system contracts for the services of various independent consulting, investment advisory and financial professionals to assist the Board of Trustees in carrying out its fiduciary responsibility to efficiently and effectively manage the system. Actuarial services were provided by Gabriel Roeder Smith & Company and independent financial statement audit services were provided by SB & Company, L.L.C. The system’s asset custody and portfolio accounting services were provided by the State Street Bank & Trust Company under a multi-year, master custody arrangement. Hewitt Ennis Knupp, Inc. serves as the system’s general investment consultant. Specialty consulting services are provided by Altius Associates Limited and Pension Consulting Alliance, Inc. for private equity and real estate, respectively. Albourne America LLC advises staff on the retirement system’s Absolute Return portfolio and Wilshire Associates provides risk consulting services. A complete listing of the system’s professional consultants and external investment advisors is presented on page 11.

Awards

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the Maryland State Retirement and Pension System for its Comprehensive Annual Financial Report for the fiscal year ended June 30, 2012. This was the twenty-fourth consecutive year (1989 through 2012) that it has received this prestigious award. In order to be awarded a Certificate of Achievement, a governmental unit must publish an easily readable and efficiently organized comprehensive annual financial report. This report must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe our current comprehensive annual financial report continues to meet the Certificate of Achievement Program’s requirements, and we are submitting it to the GFOA to determine its eligibility for another certificate.

Additionally, the Maryland State Retirement and Pension System received the Public Pension Coordinating Council’s (PPCC) 2013 Recognition Award for Administration, in recognition of meeting professional standards for plan administration as set forth in the Public Pension Standards.

The PPCC is a coalition of the following associations that represent public pension funds that cover the vast majority of public employees in the U.S.:

• National Association of State Retirement Administrators (NASRA)
• National Council on Teacher Retirement (NCTR)
• National Conference on Public Employee Retirement Systems (NCPERS)

The Public Pension Standards are intended to reflect expectations for public retirement systems management and administration, and serve as a benchmark by which all defined benefit public plans should be measured. The Maryland State Retirement and Pension System is proud to be a recipient of this award.

Acknowledgments

This annual report reflects the dedicated efforts of the system’s staff under the steady direction of the Board of Trustees. We extend our sincere gratitude to each member of the board, the system’s staff, the board’s advisors and the many people who worked with diligence and dedication throughout fiscal year 2013.

R. Dean Kenderline
Executive Director
Secretary to the Board

Melody Countess, CPA
Chief Operating Officer
Introduction

Maryland State Retirement and Pension System

DAVID S. BLITZSTEIN
Chairman, Corporate Governance Committee
Member, Investment Committee

KENNETH B. HAINES
Member, Administrative Committee
Member, Audit Committee

JOHN W. DOUGLASS
Vice Chairman, Audit Committee
Member, Administrative Committee

ELOISE FOSTER
Member, Administrative Committee
Member, Corporate Governance Committee
Member, Investment Committee

NANCY K. KOPP, Chairman
State Treasurer
Ex Officio since February 14, 2002
Member, Administrative Committee
Member, Corporate Governance Committee
Member, Investment Committee

PETER FRANCHOT, Vice Chairman
State Comptroller
Ex Officio since January 22, 2007
Member, Investment Committee

ROBERT R. HAGANS, JR.
Chairman, Corporate Governance Committee
Member, Investment Committee

JAMES R. BUSH, JR.
Member, Audit Committee
Member, Investment Committee

JOHN W. DOUGLASS
Vice Chairman, Audit Committee
Member, Administrative Committee

ELOISE FOSTER
Member, Administrative Committee
Member, Corporate Governance Committee
Member, Investment Committee

PETER FRANCHOT, Vice Chairman
State Comptroller
Ex Officio since January 22, 2007
Member, Investment Committee

ROBERT R. HAGANS, JR.
Chairman, Corporate Governance Committee
Member, Investment Committee

KENNETH B. HAINES
Member, Administrative Committee
Member, Audit Committee

JAMES M. HARKINS
Chairman, Administrative Committee
Member, Corporate Governance Committee

Maryland State Retirement and Pension System
Introduction

BOARD OF TRUSTEES

LINDA A. HERMAN
August 1, 2013 - June 31, 2017
Member, Audit Committee
Member, Corporate Governance Committee
Member, Investment Committee

F. PATRICK HUGHES
April 20, 2004 – June 30, 2017
Chairman, Audit Committee
Vice Chairman, Investment Committee
Member, Securities Litigation Committee

MAJOR MORRIS L. KROME
August 1, 1998 – July 31, 2014
Vice Chairman, Administrative Committee
Member, Audit Committee
Member, Investment Committee

THERESA LOCHTE
August 1, 2007 – July 31, 2015
Member, Administrative Committee
Member, Corporate Governance Committee
Member, Investment Committee

HAROLD ZIRKIN
September 10, 2007 - June 30, 2015
Chairman, Investment Committee
Vice Chairman, Securities Litigation Committee
Member, Corporate Governance Committee

THURMAN ZOLLCOFFER, JR.
September 12, 2007 - July 31, 2015
Chairman, Securities Litigation Committee
Vice Chairman, Corporate Governance Committee
Member, Investment Committee

ADVISORS TO THE INVESTMENT COMMITTEE

LARRY E. JENNINGS, JR.

WAYNE H. SHANER

BRIAN B. TOPPING
*Additional information regarding investment professionals who provide services to the System can be found on pages 11, and 61-65.
Global Custodial Bank & Security Lending
State Street Bank and Trust Company
Boston, Massachusetts

Hearing Officers
Office of Administrative Hearings
Baltimore, Maryland

Independent Actuary
Gabriel Roeder Smith & Company
Southfield, Michigan

Independent Public Accountant
SB & Company, LLC
Hunt Valley, Maryland

Independent Investment Consultants
Altius Associates Limited
Richmond, Virginia
Hewitt EnnisKnupp, Inc.
Chicago, Illinois
Pension Consulting Alliance
Encino, California
Albourne America, LLC
San Francisco, California

Medical Board
Dr. Elizabeth Adegboyega-Panox
Dr. Eroll L. Bennett
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Dr. Arthur Hildreth
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Dr. Archana Goel Leon-Guerrero
Dr. Christian E. Jensen
Dr. John Parkerson
Dr. William B. Russell
D. William Smulyan
Dr. Zia Zakai

Operational Banking Services
M & T Bank
Baltimore, Maryland
The Harbor Bank of Maryland
Baltimore, Maryland
Certificate of Achievement for Excellence in Financial Reporting

Presented to
Maryland State Retirement and Pension System

For its Comprehensive Annual Financial Report for the Fiscal Year Ended

June 30, 2012

Jeffrey R. Erwin
Executive Director/CEO

Government Finance Officers Association
Public Pension Coordinating Council

Recognition Award for Administration
2013

Presented to

Maryland State Retirement and Pension System

In recognition of meeting professional standards for plan administration as set forth in the Public Pension Standards.

Presented by the Public Pension Coordinating Council, a confederation of

National Association of State Retirement Administrators (NASRA)
National Conference on Public Employee Retirement Systems (NCPERS)
National Council on Teacher Retirement (NCTR)

Alan H. Winkle
Program Administrator
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