

MERS

A Safe Harbor

MUNICIPAL EMPLOYEES' RETIREMENT SYSTEM OF MICHIGAN
COMPREHENSIVE ANNUAL FINANCIAL REPORT
FISCAL YEAR ENDED
DECEMBER 31, 2004



Cover: Holland Harbor South Pier Lighthouse, State Historic Preservation Office, Michigan Historical Center, Department of History, Arts and Libraries, www.michigan.gov/SHPO

Lighthouses in order of appearance on
Title page: Holland Harbor South Pier Lighthouse, David Vaughn
Divider pages (left to right):
Frankfort North Breakwater Light, Travel Michigan;
Big Sable Point Lighthouse, David Vaughn;
Tawas Point Lighthouse, Michigan Department of Natural Resources;
Sturgeon Point Lighthouse, Vito Palmisano.
Pictures provided by Michigan Economic Development Corporation's
Official Economic Development and Travel Site, www.travel.michigan.org

Lighthouse theme suggested by MERS staff members:
Mark Drury, Jennifer Mausolf, Michael Moquin, Sheila Parsons.

MERS

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COMPREHENSIVE ANNUAL FINANCIAL REPORT
FISCAL YEAR ENDED DECEMBER 31, 2004

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CHIEF EXECUTIVE OFFICER

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CHIEF FINANCIAL OFFICER



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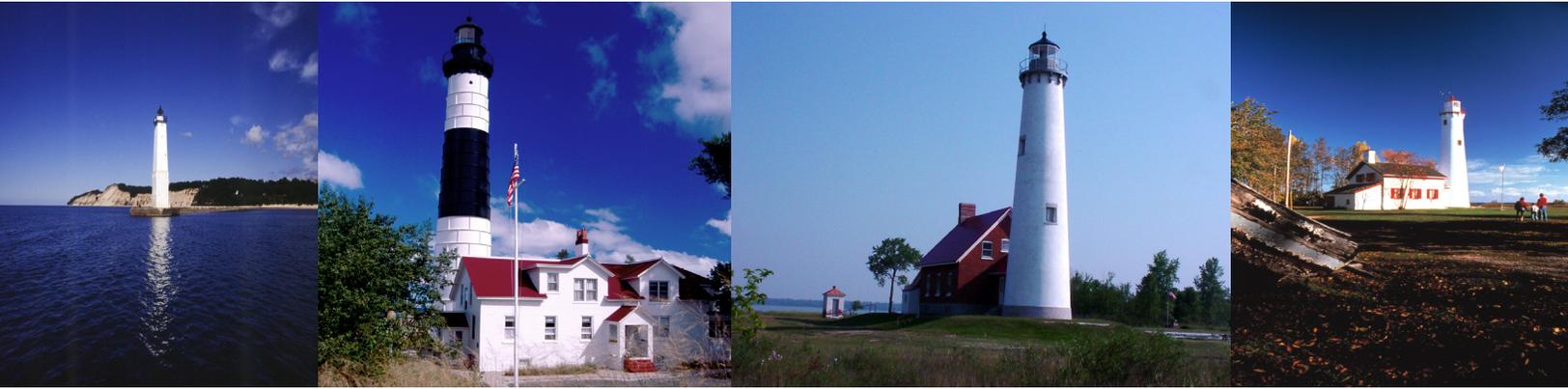
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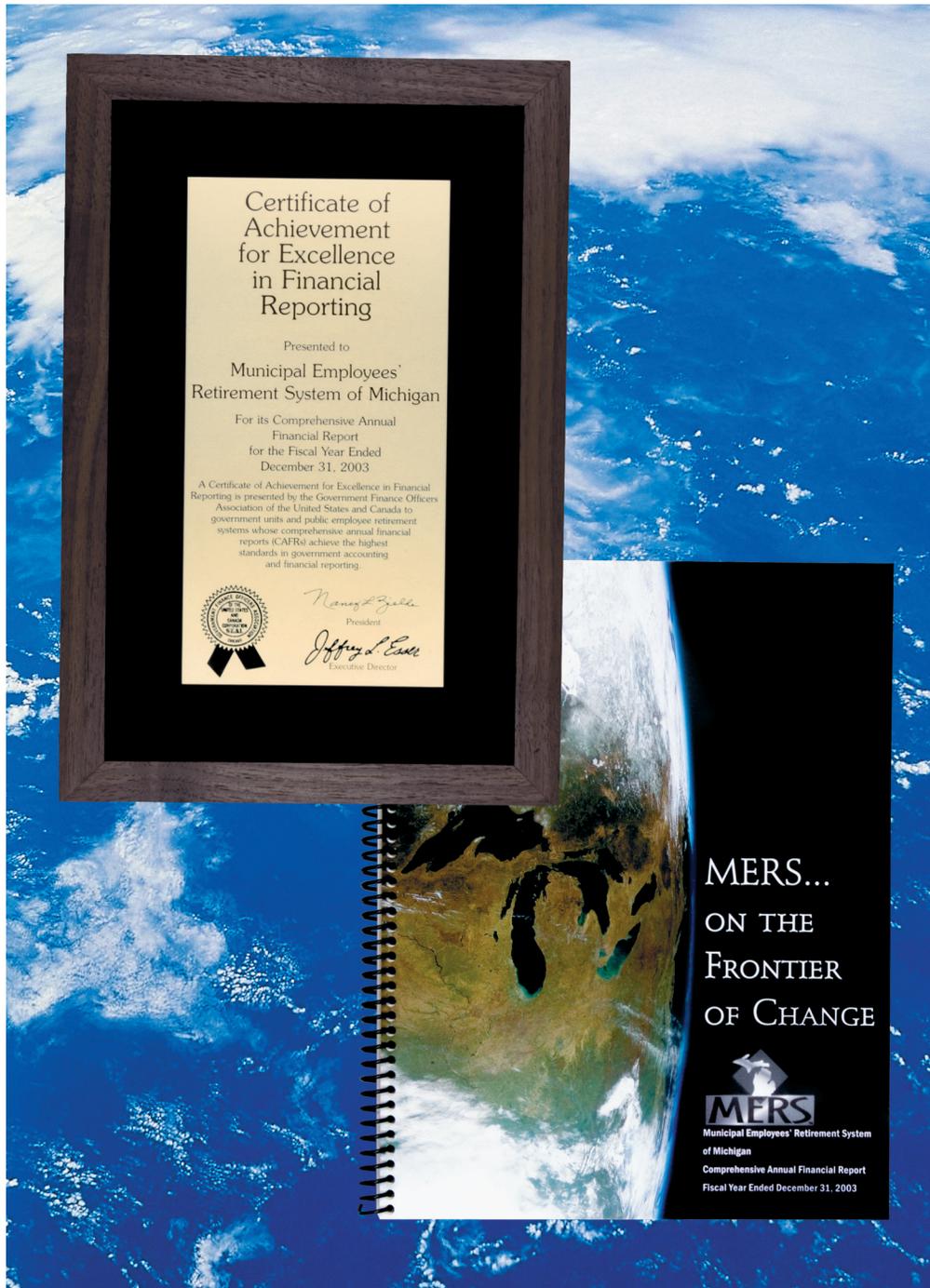
Introductory



“We are told to let our light shine, and if it does, we won’t need to tell anybody it does. Lighthouses don’t fire cannons to call attention to their shining—they just shine.”

—Dwight L. Moody

Introductory Section



MERS received the Certificate of Achievement for Excellence in Financial Reporting from the Government Finance Officer's Association for the December 31, 2003 Comprehensive Annual Financial Report. This marks the 16th consecutive year MERS has received this honor.

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LETTER OF TRANSMITTAL



June 1, 2005

The Retirement Board
Municipal Employees' Retirement System of Michigan
1134 Municipal Way
Lansing, Michigan 48917

Dear Board Members:

It is a pleasure to present the Comprehensive Annual Financial Report (CAFR) of the Municipal Employees' Retirement System of Michigan (MERS) for the fiscal year ended December 31, 2004. This is the 58th year that MERS has provided retirement plan administration to its member municipalities across the great state of Michigan. It was a hallmark year because MERS offered several new insurance products, under the umbrella of Group Health Solutions, to its membership.

MERS, from its inception under state legislature in 1945, continues to provide an avenue for local governing bodies to pool their resources to offer retirement benefits for the welfare of their member employees. Over the years, many advances have been made to improve the benefits and services to members. With that mandate in mind, MERS is proud to offer the same capability in the area of health care.

As a voluntary statewide organization, MERS continues to increase its membership roster. Examples of that growth are found in the Introductory Section. This section includes: Letter of Transmittal, Letter from the Chairperson of the Retirement Board, the GFOA Certificate of Achievement, administrative organizational details, and a review of MERS activities covering both the Defined Benefit (DB) Plan and the Defined Contribution (DC) Plan.

LETTER OF TRANSMITTAL

This 2004 CAFR also contains the following sections:

- **Financial Section.** Management's Discussion and Analysis (MD&A), report of the independent auditor, and the Retirement System's financial statements and supplemental information for the DB Plan.
- **Investment Section.** Summary of investment activity, an explanation of investment policy, portfolio performance information, and various investment schedules for both the DB and DC plans.
- **Actuarial Section.** Actuary's certification letter and summaries for the DB Plan.
- **Statistical Section.** Statistical information on both plans.

The responsibility for the accuracy and completeness of the financial data and the fairness of the presentation rests with the Chief Executive Officer and the management of MERS.

MERS members, as of December 31, 2004, included employees from 619 municipalities across the state (see page 26).

Financial

The basic financial statements have been prepared in accordance with Generally Accepted Accounting Principles (GAAP) applied on a consistent basis as promulgated by the Governmental Accounting Standards Board and its predecessor, the National Council on Government Accounting. The MD&A provides a narrative introduction, overview, and analysis to accompany the basic financial statements. This Letter of Transmittal is designed to complement the MD&A and should be read in conjunction with it. The MD&A can be found in the Financial Section immediately following the independent auditor's report (see pages 18-23).

Investments – Defined Benefit Portfolio

The extension of strong U.S. equity market returns through the fourth quarter resulted in a second consecutive year of robust returns in the portfolio. The portfolio returned 14.9 percent for the one year period ending December 31, 2004, and 10.3 percent for the 10-year period. The one-year return places the portfolio in the fourth percentile in The Northern Trust Public Funds Universe. This universe is comprised of 34 plans with a total market value of \$198 billion. The plans range in size from \$54 million to \$33.7 billion with a median market value of \$3.1 billion.

LETTER OF TRANSMITTAL

The 2004 fourth quarter rebound in the small cap international stock produced returns in excess of 9.12 percent over benchmark. Likewise, MERS domestic equity managers outperformed the Russell 3000 by .93 percent. This plus performance significantly contributed to the portfolio's stellar returns. The portfolio ended the fiscal year with \$4.6 billion in assets.

The fixed income portfolio continued its modest pace during the year, providing marginally positive returns for the year at 7.4 percent versus the Lehman Aggregate Bond Index at 4.3 percent. The Federal Reserve tightening of interest rates during November and December did not negatively influence bond investors from increasing their investment-grade bond positions.

MERS strict adherence to its strategic asset allocation model provides discipline as well as the ability to take advantage of opportunities that occur in the global market place. MERS conducts a strategic asset allocation study every five years and annually rebalances the assets to the selected target asset allocation model.

Please refer to the Investment Section (beginning on page 43) for more detailed comments on the portfolio.

Funding

The most recent Actuarial Valuation, dated December 31, 2003, revealed that the DB Plan has a funding percentage of 78 percent. MERS receives no state funded contributions. Each member municipality is legally responsible for funding the pensions earned by their employees under the provisions of the Michigan Constitution and the MERS Plan Document. Each municipality is a separate trust account in MERS. The pension obligations are paid from that account. MERS does not fund or borrow from one municipality's account to cover another municipality's obligation to pay its pensioners.

INITIATIVES

Health Care

After an extensive three-year period of discovery, MERS expanded the retirement fund's capabilities to include health care. These programs, under the umbrella MERS Group Health Solutions, currently include the Health Care Savings Program, Retiree Health Funding Vehicle for Other Postemployment Benefits (OPEB), and MERS Premier Health. These programs became available to the membership for the first time during the fiscal year and now join the Group Life and Disability Insurance program that was introduced in the fall of 2003.

While this is an exciting and daunting undertaking for MERS, our commitment remains to provide economies of scale, continuity of service, and much needed relief in the area of problematic health care for the communities of Michigan. Volume buying will allow for that economy. Many municipalities are facing

declining resources and ever expanding costs in health care. MERS is dedicated to addressing this problem by endeavoring to contain the rising costs faced by our membership.

The Group Life and Disability Insurance program enjoys substantial success with over 5,000 participants enrolled. Collectively, MERS has provided savings of more than \$1 million in premium dollars to the membership. These programs became effective on January 1, 2004, with a renewal date of January 1, 2006, and have a 24 month premium rate guarantee. The Standard Insurance Company of Portland, Oregon administers these programs.

The Health Care Savings Program is designed to be an employer-sponsored program. This allows employers to set aside pretax contributions during an employee's working years to be used after termination of employment for medical expenses (as defined by the Internal Revenue Service). The payouts remain tax-free. This program received a Private Letter Ruling from the IRS and became effective June 1, 2004.

MERS Premier Health is a MERS sponsored medical insurance program for its active and retired members. The program provides quality insurance coverage for health care, vision care, dental care, and prescriptions. MERS applied to the State of Michigan's Office of Financial and Insurance Services in February 2004 to become the first public Multiple Employer Welfare Arrangement (MEWA) in the state. The provisional certificate was granted the following September and final approval was received in December. An interim Board oversees this program which started January 1, 2005.

Technology

MERS continues to expand the use of web-based capabilities to ensure effective communication with the membership.

The new "electronic Payroll and Service System" (ePASS) designed to facilitate the ease of transferring information from the employer to MERS was completed in September 2004. The rollout to the members will be accomplished by region with approximately 50 employers joining the program each month. This will allow enough time to answer questions and ensure that employers are comfortable with the new program.

A new Pension Administration system, MERS Automated Pension System (MAPS), is currently being developed. This software will replace the PeopleSoft pension administration software currently in use. The goal is to expand our capabilities to capture information, eliminate redundant entry, and achieve superior data integrity.

MERS continues to work hard to provide excellent service and retain the trust of our membership. We look back over MERS history with satisfaction and pride, while at the same time remaining committed to proactively addressing the technology needs of the future.

LETTER OF TRANSMITTAL

Awards

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to MERS for its Comprehensive Annual Financial Report for the year ended December 31, 2003. This was the 16th consecutive year that MERS has achieved this prestigious award.

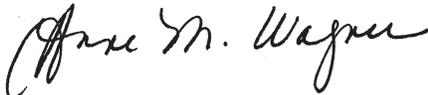
In order to be awarded the Certificate of Achievement, a government unit must publish an easily readable and efficiently organized comprehensive annual financial report. This report must satisfy both GAAP and applicable legal requirements. A Certificate of Achievement is valid for a period of one year only. We believe this current report continues to meet the Certificate of Achievement Program requirements, and we are submitting it to the GFOA to determine its eligibility.

In addition, in 2004 MERS was awarded the GFOA budget award for its 2003 budget submission.

Acknowledgments

This report reflects the best combined efforts of the MERS staff under the leadership of the MERS Retirement Board. I would like to take this opportunity to commend its efforts on creating another outstanding report. Additionally, I want to express my gratitude to the staff, advisors and many other people and organizations who have worked so conscientiously to assure the success of the Municipal Employees' Retirement System of Michigan.

Respectfully submitted,



Anne M. Wagner
Chief Executive Officer

LETTER FROM THE CHAIRPERSON



Our present is your future

June 1, 2005

Dear Members:

On behalf of the MERS Retirement Board, I am pleased to present the Municipal Employees' Retirement System's 58th Comprehensive Annual Financial Report (CAFR) for the fiscal year ended December 31, 2004. This financial report provides information on the status of our retirement system. Significant changes that have occurred during the year are highlighted.

Last year, the diversification in the Defined Benefit portfolio delivered a 14.9 percent return for the one-year period and 9.4 percent for the ten-year period. These returns go a long way to recover from the three years of under-performance experienced in 2000-2002. The Board's investment policy continues to focus on preserving the Retirement System's assets while maximizing the long-term growth of those assets.

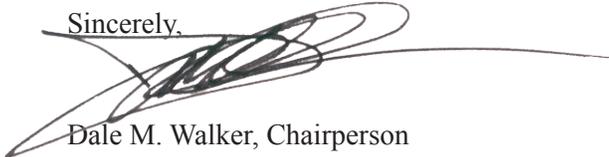
Retirement seminars and Regional Meetings continued in 2004 both in the home office and around the state. Retirement seminars are designed for those members contemplating retirement in the next three to five years. Regional Meetings cover pension, employee benefits, health care, and insurance topics of interest to employers and employees. The major project undertaken to rewrite the wage and service software, "electronic Payroll and Service System" (ePASS), was completed in September. ePASS expands MERS use of eCommerce to collect payroll information from our participating municipalities.

At the 2004 Annual Meeting, delegates elected me, Dale Walker, Finance Director from the City of Cadillac, and Sally Dreves, Human Resources Technician from Grand Traverse County, to three-year terms (January 1, 2005 - January 1, 2008) on the Board as Officer and Employee members, respectively. The nine member Retirement Board continues to work diligently to serve the membership and fulfill its fiduciary responsibilities. MERS greatly benefits from the Board members' diverse expertise and experience. It is a privilege for me to serve as Chairperson along with trustees of such high caliber and dedication.

If you have any questions regarding this report or other retirement questions, please contact us at (800) 767-6377, or send a letter addressed to MERS, 1134 Municipal Way, Lansing, MI 48917.

In closing, I wish to thank the Board members and staff for continuing to maintain their high level of commitment and service to the Retirement System's participants. The members of this Retirement System should be very proud of the excellence and dedication presented to you in order that we all may have the necessary funds available to provide for retirement. Our present is your future.

Sincerely,



Dale M. Walker, Chairperson
MERS Retirement Board

MERS RETIREMENT BOARD
2004



Standing (left to right): Dennis Murphy, Raymond Klosowski, Bruce Johnson, Larry Opelt, Gary Murphy, John Ogden.

Seated (left to right): Barbara Fandell, Dale Walker, Kristen Wade.

Chairperson-Officer Member
Mr. Dale Walker, Chairperson
City of Cadillac

Employee Member
Mr. Raymond Klosowski
Isabella County

Chairperson Pro-Tem
Employee Member
Ms. Kristen Wade
Muskegon County

Public Member
Mr. Dennis Murphy
Novi, MI

Employee Member
Ms. Barbara Fandell
City of St. Louis

Officer Member
Mr. Gary Murphy
City of East Lansing

Public Member
Mr. Bruce Johnson
Holland, MI

Officer Member
Mr. John Ogden
City of Port Huron

Retiree Member
Mr. Larry Opelt
Adrian, MI

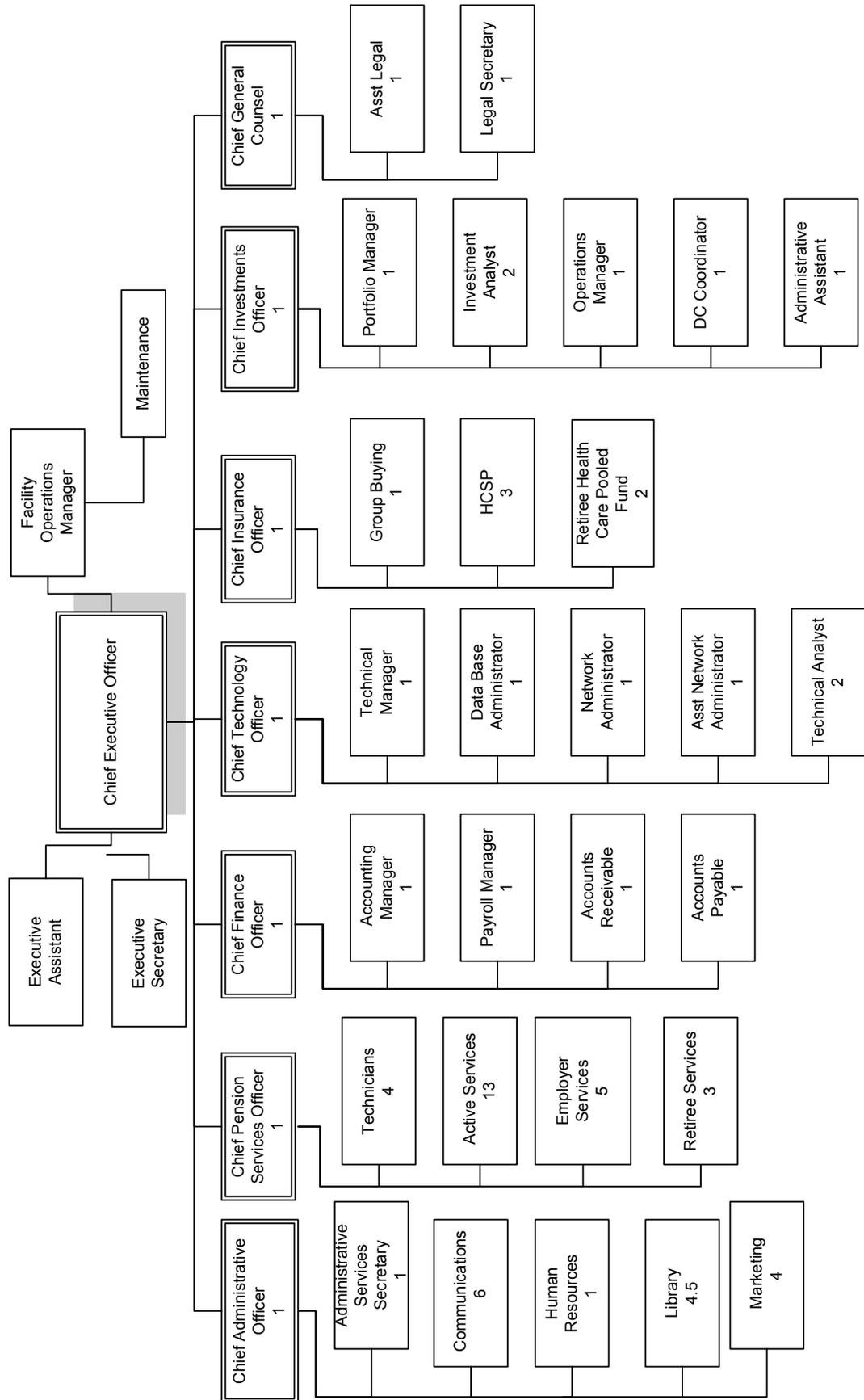
ADMINISTRATIVE ORGANIZATION



Officers: (Standing left to right): Debra Peake, Chief Pension Services Officer; Kathy House, Chief Marketing Officer; Anne M. Wagner, Chief Executive Officer; Tama Allen, Chief Technology Officer; Carrie Lombardo, Chief Insurance Officer.
(Seated left to right): Michael Moquin, Chief General Counsel; Luke Huelskamp, Chief Financial Officer; Jeb Burns, Chief Investments Officer; William SaintAmour, Chief Administrative Officer.



ORGANIZATIONAL CHART - 2004



Outside Professional Services

Professional Consultants

Actuary

Gabriel, Roeder, Smith and Company

Auditor

Andrews, Hooper & Pavlik, PLC

Defined Contribution Plan Third-Party Administrator

International City/County Management Association Retirement Corporation (ICMA-RC)

Investment Custodian

The Northern Trust Company

Legal Counsel

Ice Miller Donadio & Ryan
John Eggersten, P.C.
Lisa Ward
Loomis, Ewert, Parsley, Davis & Gotting, P.C.
Miller, Canfield, Paddock & Stone, PLC

Legislative Consultants

Karoub Associates

Medical Advisor

Associated Physicians
Consulting Physicians

Security Lending Agent

The Northern Trust Company

Systems Implementation and Maintenance

Gabriel, Roeder, Smith and Company
Logicalis
PeopleSoft USA, Inc.

Investment Managers

Domestic Equity

Ariel Capital Management
Armstrong Shaw Associates
Barclays Global Investors
Kennedy Capital Management
Trust Company of the West (TCW) Asset Management
Wasatch Advisors
Wellington Management Company
World Asset Management

International Equity

Acadian Asset Management
Barclays Global Investors
Mondrian Investment Advisors

Fixed Income

Barclays Global Investors
Evergreen Investments
Reams Asset Management
Western Asset Management

Real Estate

Townsend Group Consultants
AEW Capital Management
Guggenheim Structures Real Estate Fund
Hancock Timber Resources
J.P. Morgan Investment Management
KBS Realty Advisors
Lend Lease Rosen
Prudential Property Investment
SSR Realty Advisors, Inc.
The Campbell Group
UBS Realty Investors, LLC
Urdang Investment Management