Michigan blueberries

Did You Know?

- Michigan leads the nation in growing blueberries
- Over 600 family farms contribute nearly $101.8 million in blueberry production to the state's economy
- About 69 percent of the harvest is frozen or canned
- Blueberries promote heart health and help fight cancer
- A one cup serving gives you five grams of fiber and 15 percent of your daily vitamin C

CHIEF INVESTMENT OFFICER REPORT

Municipal Employees' Retirement System of Michigan

Dear Members:

It is my privilege to present the Report on Investment Activity for the MERS Comprehensive Annual Financial Report for the calendar year 2010. As of this report, MERS total plan had net assets of $6.6 billion. In 2010, the Total Market Fund generated $817 million in earnings.

The defined fund objective, based upon actuarial valuations, is to grow assets at a rate which, when coupled with contributions, satisfies earned benefits to MERS members. The Office of Investments strives to achieve a real rate of return of at least 3.5% annually over the rate of inflation, and/or exceed the actuarial assumption rate of 8% annually. On a relative basis versus our various objectives and peers, MERS performed very well in 2010. Below are a few highlights:

- The MERS Total Market Fund return for 2010 was 14.12% (net of fees), which outperformed the actuarially assumed rate of 8%. This will work favorably to reduce future contributions from MERS members.
- The MERS Total Market Fund outperformed its custom policy benchmark (net of fees) by 0.89%. This highlights that the Total Market Fund asset allocation, with active management, generated $48 million above what would have been earned if it had been invested passively.
- At the broad asset class level, absolute returns (net of fees) for each class were positive in 2010:
  - Total Equity 18.81%
  - Real Estate 4.19%
  - Fixed Income 7.88%
  - High Yield 16.22%
  - Commodities 15.04%
  - Private Equity 15.52%
  - Cash 2.01%
- A $10,000 Total Market Fund investment made in 1988 would have been worth $69,686 at the end of 2010. This is $13,724 above what would have been earned if the Total Market Fund had been invested passively.

The past year was a carnival ride as the markets lurched back and forth between a constructive cyclical backdrop, and an extremely challenging set of structural issues that bubbled up due to the aftermath of the global financial crisis. Incredibly, the crisis in Europe was not enough to derail a fledgling recovery, and fears of a double-dip recession here in the U.S. were erased in the minds of many investment professionals by midyear.

In fact, U.S. stocks rose strongly for a second consecutive year, with the S&P 500 gaining 15.1%. Since the market's March 2009 bottom, the S&P has risen nearly 80% as corporate profitability exceeded expectations. Small and midcap sized companies substantially outperformed the larger ones as the Russell 2000 and midcap indices returned 26.9% and 25.5%, respectively, versus the Russell Top 200 Index's 12.5% return. The Federal Reserve's quantitative easing program (QE2) accounted for an overly positive view on equities, and risk in general.

QE2 also brought increased inflation expectations to Wall Street and higher Treasury yields at year-end, producing negative fixed-income results during the fourth quarter. Nevertheless, bond results were moderately strong for 2010 as Treasury yields fell, and the Barclays Aggregate Index returned 6.5%.

Most non-U.S. stock markets also posted reasonably strong returns in 2010. The MSCI EAFE Index rose 8.2% on sustained global growth, although results were divided between weaker European returns and strong results in Asia, Canada and many less-developed nations. Emerging market

returns varied substantially. Many smaller nations produced gains of 20 to 30% or more, driven by booming commodity prices and substantial capital inflows. However, China and Brazil lagged the broad MSCI EAFE Index, as these large markets grappled with rising inflation, currency pressures, capital flow and lending restrictions.

Policy mistakes in developed nations continued to be of great concern for most market participants in 2010.

Total Market Fund

The MERS Office of Investments conducts a full asset allocation study every five years to assess portfolio construction and strategy. The MERS Board adopted our most recent asset allocation recommendation in July of 2010. The asset allocation is reviewed annually per Board policy to rebalance where needed. The Board may revise the plan when necessary; the Office of Investments tactically allocates the portfolio within established asset class bands. (See chart below.)

Asset Class	Target Weight	Minimum Allocation	Maximum Allocation
Domestic Equity	34.50%	30.50%	38.50%
International Equity	10.00	6.00	14.00
Fixed Income	30.00	26.00	34.00
High Yield	5.00	1.00	9.00
Private Equity	7.00	3.00	11.00
Real Estate	7.00	3.00	11.00
Commodities	5.00	3.00	7.00
Cash	1.50	1.00	3.00

As the global economy floundered for most of 2010, we decided not to make any tactical bets versus our Policy Asset Allocation set by the MERS Board. Additionally, to help us rebalance back to our Policy more efficiently, we implemented a customized overlay solution providing MERS Office of Investments a low-cost solution for managing risk and enhancing expected return. This solution generated an additional 9 basis points or $5.6 million above what would have been earned had the strategy not been implemented.

Looking Ahead

As we look ahead at an ever-evolving investment world, we continue to be vigilant in our search for new investment opportunities. It is our view that the global landscape will continue to shrink at an unprecedented pace, and that a majority of global growth will come from non-developed nations. With this theme in mind, we are looking to position the portfolio to capture growth in terms of total return for the Total Market Fund and MERS members.

Conclusion

Lastly, I would like to thank the Retirement Board, the fiduciaries of the MERS plan, for their enthusiasm in creating a structure that provides the Office of Investments the ability to be flexible and innovative. Our structure is continually praised by investment managers and peers, and makes for a more efficient decision-making process in a world that now moves at blinding speeds.

Respectfully,

Jeb Burns
Chief Investment Officer

REPORT ON INVESTMENT ACTIVITY

MERS was established in 1946 under 1945 PA 135, and granted independence from the State of Michigan pursuant to 1996 PA 220, effective August 15, 1996. MERS is organized for the express purpose of using its collective resources to ensure that its member municipalities have sufficient financial resources to meet the pension obligations that each such municipality is individually responsible for under Constitution 1963, Article 9, Section 24. MERS is authorized to create subsidiary entities and to provide additional benefits and savings to its members at the direction of the Board. See 2004 PA 490, Section 36(2)(a); MCL 38.1536(2)(a).

The MERS Retirement Board (Board), as "investment fiduciary" under the Public Employee Retirement System Investment Act (PERSIA), 1965 PA 314, has the fiduciary responsibility and authority to direct the Retirement System's investment program. Members of the Board must follow the state law and prudent standards of diligence consistent with "discharging their duties for the exclusive benefit of plan participants." The prudent person standard requires that the Board "exercise the same judgment, care, skill, prudence, and diligence under the circumstances which persons acting in a like capacity and familiar with such matters would use in the conduct of a similar enterprise with similar aims." MERS has a Defined Benefit Plan, Health Care Saving Plan, Retiree Health Funding Vehicle, Hybrid Plan and a Defined Contribution Plan. The Board has granted full discretion to manage all investment management operations and activities to MERS Office of Investments, except those specifically reserved for the Board.

The Municipal Employees' Retirement System Investment Management Plan outlines how the policy objectives described in the MERS Plan Document, Investment Guidelines, and the Asset Allocation Policy are to be achieved. The investment activity goals are to provide the highest quality investment management and administrative support. These goals are measured against established industry benchmarks and peer groups. The objective is to ensure that the investment activities are carried out within the framework established by MERS policy and administrative documents. The Investment Management Plan offers a map to assist the Board and staff in making prudent and informed investment decisions.

Did You Know?

A new combine, which farmers use to harvest corn, soybeans and other grains, could cost as much as $300,000 or more

A. Defined Benefit Plan

INVESTMENT OBJECTIVES AND ACTIVITY

In conformity with PERSIA, the primary objective is to maximize the long-term total rate of return on investments. This should be done with a high degree of prudence to reduce risk. In addition, the Board and the Office of Investments has established Investment Guidelines that are updated annually. These Guidelines communicate long-term objectives, goals, and performance expectations to the staff, investment managers, consultants, and any other interested parties. The Board strives to add incremental returns relative to the market by employing active management strategies when needed. Every effort is made to minimize costs to the portfolio with the use of internal and external resources.

The defined fund objective, based upon actuarial valuations is to grow assets at a rate which, when coupled with contributions, satisfies promised benefits to MERS members. The Office of Investments strives to achieve a real rate of return of at least 3.5% annually over the rate of inflation; and exceed the actuarial assumption rate of 8% annually.

FUND OBJECTIVE CONSIDERATIONS

- Adopt a strategic asset allocation plan that reflects future liabilities and incorporates risk parameters
- Structure investment goals over a long-term horizon (five years)
- Use actuarial methods that decrease the impact of volatility
- Concentrate on asset classes that have added value over the rate of inflation
- Measure comparability to other plans to reflect the need to remain near industry standards
- Employ the use of beta strategies, where applicable, to form a core base in the portfolio and reduce costs
- Use commission recapture to reduce transaction costs and increase earnings to the total fund
- Employ a manager (i.e. custodian bank) to lend held securities of the total portfolio to add incremental income
- Use all asset classes to capitalize on global economic growth
- Allow investment managers increased flexibility so they can tactically exploit broad market trends
- Tactically allocate the portfolio to take advantage of short and long-term market inefficiencies, trends and dislocations which can add moderate returns above the policy benchmark

PORTFOLIO HIGHLIGHTS

Asset Allocation

Determining the system's asset allocation is regarded as one of the most important decisions in the investment management process. With this in mind, the Office of Investments conducts a full asset allocation study every five years to assess portfolio construction and strategy. Factors considered are: expected rate of return for each asset class, expected risk of each asset class, the correlation between the rates of return of each asset class and the investment objectives and risk constraints of the fund.

The Office of Investments uses risk management software to perform a strategic analysis of asset allocation levels on an ongoing basis. This process establishes a formal risk budget and quantifies asset allocation decisions.

The Board adopted the most recent asset allocation study in July 2010. The current plan is: Domestic Equity – 34.5%, International Equity 10%, Fixed Income – 30%, High Yield – 5%, Real Estate – 7%, Private Equity – 7%, Commodities – 5%, and Cash – 1.5%.

Tactical Asset Allocation

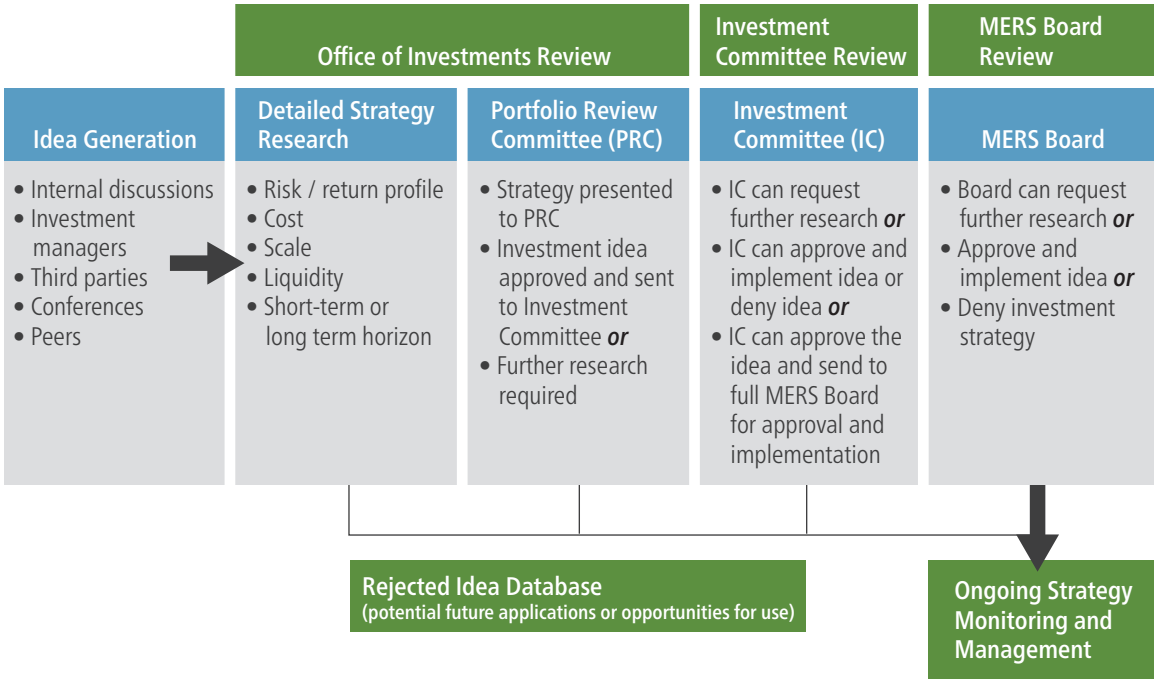
As the financial markets and economic conditions change, certain asset classes become more favorable than others. Therefore, it is necessary to engage in short-term, tactical deviations from the strategic allocation in order to capitalize on unusual or exceptional investment opportunities. Since the markets are so dynamic, these moves will be made very quickly in an effort to take advantage of short-term systemic inefficiencies and broad market trends. MERS Office of Investments feels that engaging in such tactical deviations is necessary to produce superior investment returns from a risk/return perspective.

The team is well positioned to identify appealing investment opportunities through the use of countless quantitative and qualitative tools. These tools include insight from existing investment managers, research databases, third-party research, and financial publications, among numerous others. There is no timetable for these tactical deviations, but they will typically have a duration of less than one year. Once the short-term opportunities have run their course, the portfolio will be rebalanced to the overall strategic asset allocation.

Emerging Manager Program

Separating ourselves from a herd mentality is sometimes challenging and requires foresight. The MERS Emerging Manager Program seeks to do just that. The objective is to create additional alpha by establishing a "bullpen" of up and coming managers to replace probationary managers. Additionally, this program provides: access to a wider universe of talented investment managers, enhances internal manager searches and replacement processes, and creates a "think tank" or testing mechanism for appealing new investment strategies to determine if they should be included in the overall portfolio.

Investment Strategy Implementation Process



Did You Know?

There are approximately 56,014 farms in Michigan with farmers caring for more than 10 million acres

INVESTMENT THEMES

As the Fund continues to evolve, several prevalent themes have emerged as guiding philosophies for the Fund's structure. These broad-based themes will continue to be strongly considered in our decision-making process as we look for opportunities in the future.

Global Growth

Rapid economic growth in emerging markets such as China and India have created tremendous investment opportunities. Over the last few years, MERS has made numerous investments in an effort to diversify the portfolio and take advantage of global economic growth. MERS has made investments in commodities, emerging markets, frontier markets, and infrastructure bearing this theme in mind. Going forward, we expect to increase our allocation to these asset classes in addition to investing in new ones. We will make a shift toward global equity mandates rather than differentiating between international or domestic equity.

Active/Passive Mix

Historically, the fund has tried to maintain an active/passive mix of 2/3 active and 1/3 passive. However, in light of recent market events and unique investment opportunities, the Fund will exhibit a more passive approach. The new allocation will likely be a minimum 50/50 split between active and passive management. A more passive approach will allow for greater flexibility to invest in unique investment opportunities. Furthermore, active managers have struggled in recent years to beat passive benchmarks, and during the recent market turmoil they have offered little downside protection. A more passive allocation will also drastically decrease management fees without sacrificing returns.

Opportunistic Investing

The recent turmoil in the financial markets and the push for alternative energy and green technology has resulted in tremendous investment opportunities. In an effort to further diversify the portfolio and capture additional alpha, MERS Office of Investments will continue to seek out these opportunistic investments. This may result in the portfolio maintaining higher cash balances during certain time periods.

Expanded Mandates

In an effort to give skilled managers a better opportunity to deploy their skills, the Fund will move toward expanded mandates such as TAA Programs, all cap and core strategies, among several others.

TOTAL MARKET FUND REVIEW

MERS investments generated a return of 14.12% (net of fees) for the calendar year 2010. The Total Market Fund return exceeded its custom policy benchmark of 13.24%. Performance across all asset classes varied during the year with small cap and mid cap stocks generating some of the highest returns – 25.77% and 24.54% (net of fees), respectively. MERS total domestic stocks returned 21.23% (net of fees).

Asset Classes Performance for 2010 (net of fees) and Contribution to Total Return

Type	2010 Return	Contribution to Total Return
Domestic Stocks	21.23%	6.48%
International Stocks	13.14	1.72
Fixed Income	7.88	1.78
High Yield	16.22	1.14
Real Estate	4.19	0.22
Private Equity	15.52	1.50
Commodities	15.04	0.78

Portfolio Rebalance Policy

It is the responsibility of the Office of Investments to ensure that the portfolio remains within the asset allocation parameters established by the Board, and adheres to the system's rebalancing policy. The policy is designed to minimize drift within the portfolio, allow tactical shifts to take that advantage of market conditions, and ensure adequate cash levels are maintained within the cash account to meet ongoing pension fund expenses.

Daily Review and Optional Rebalance

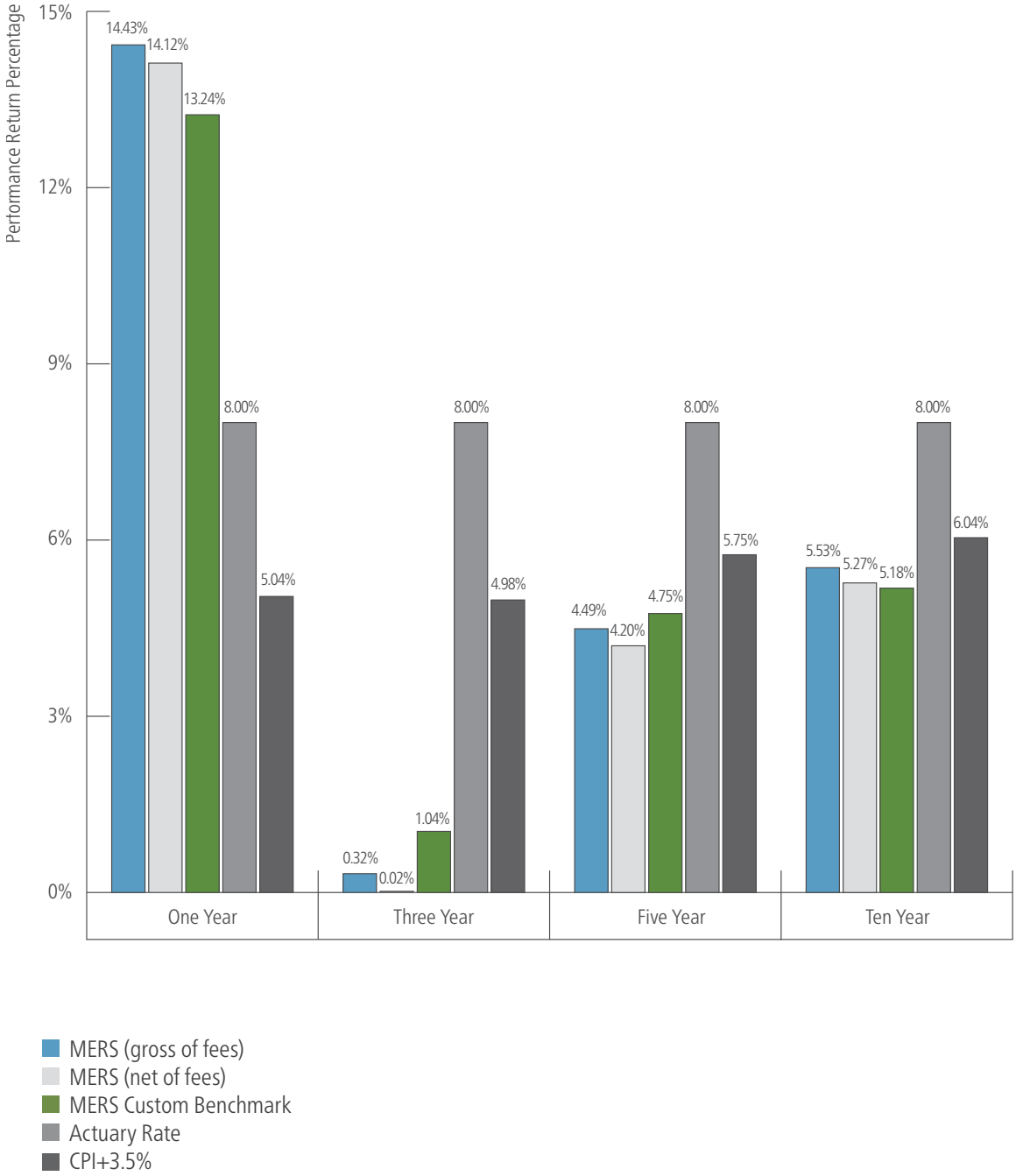
In an effort to minimize tracking errors at the total portfolio level, the Office of Investments works with the Clifton Group to implement a policy overlay using index futures.

Asset allocation levels for the various asset classes are monitored daily in relation to the predetermined variation bands and rebalanced using appropriate index futures. Adequate cash to cover the initial margin and variation margins for the futures exposure are made available and placed in accounts set up specifically for this purpose.

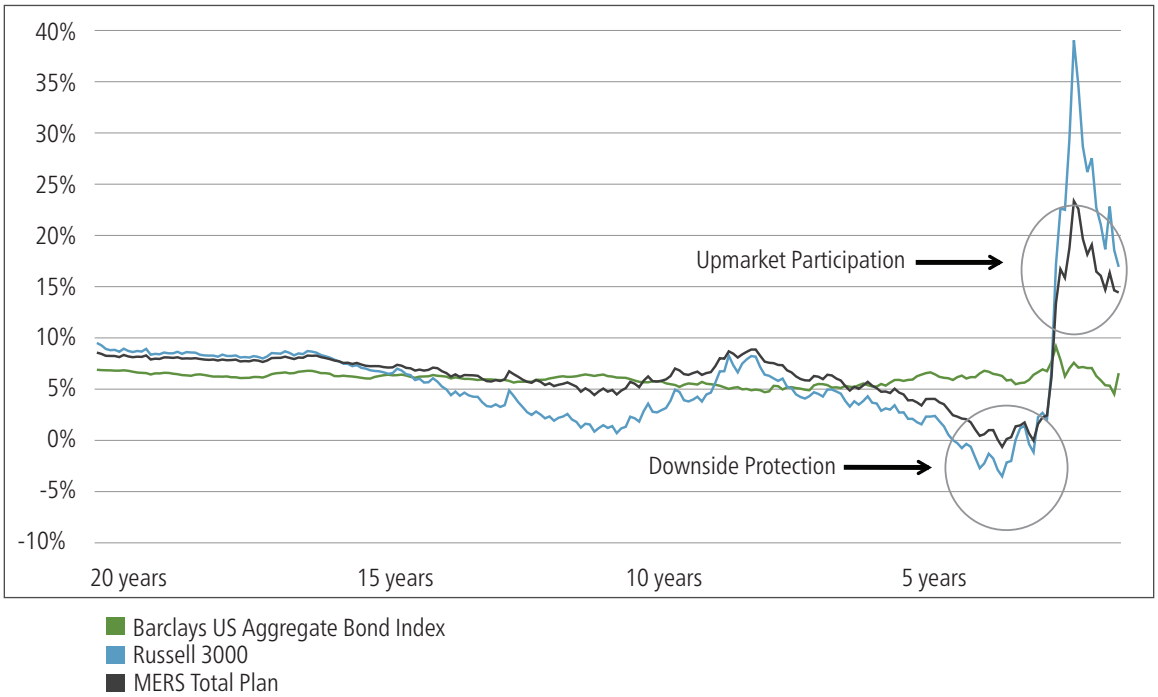
Annual Portfolio Rebalance

MERS Office of Investments performs an asset allocation analysis of the entire portfolio during the first quarter of every year. The Office of Investments has developed a rebalance plan based on this analysis.

Performance (gross and net) versus Custom Benchmarks as of December 2010



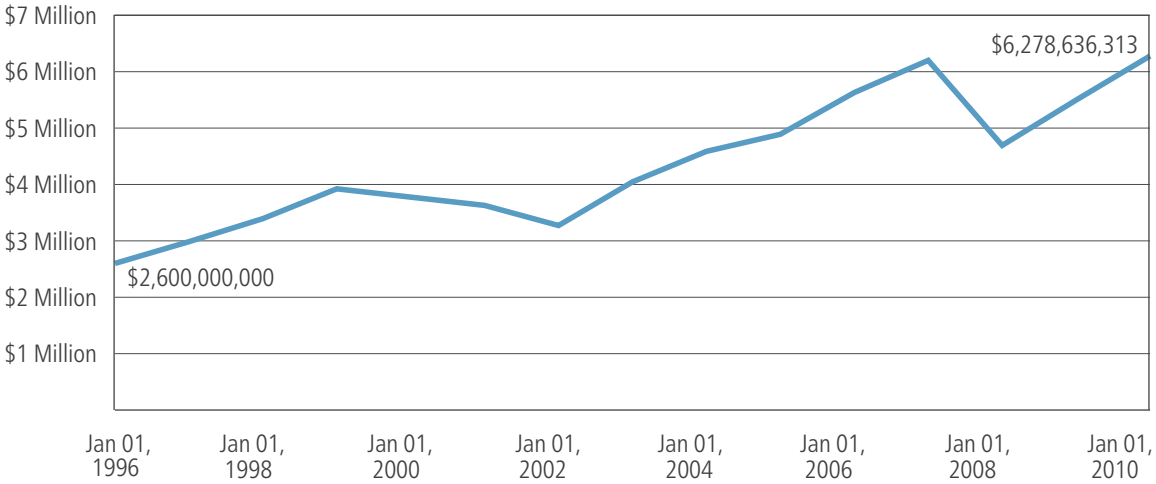
Downside Protection Upside Participation as of December 2010



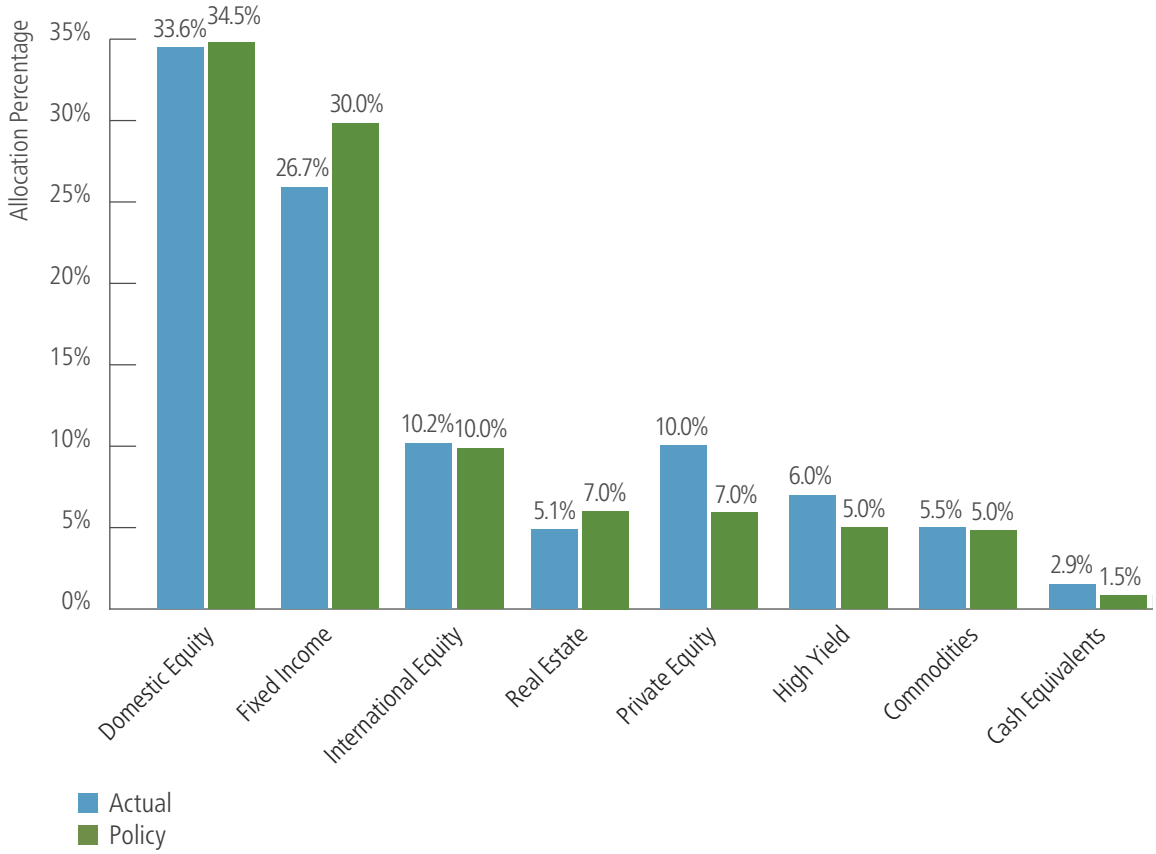
Diversification is a portfolio strategy designed to reduce exposure to the volatility of returns by combining a variety of investments (such as stocks, bonds, real estate, and commodities) which are unlikely to all move in the same direction. The goal of diversification is to reduce the risk in a portfolio.

While it is impossible to foresee all market risks, the strategic goal of the MERS asset allocation policy and the MERS Total Market Fund is to create a well-diversified portfolio, that provides downside market protection with upside market participation.

Growth of the Total Market Fund – as of December 2010



Current Asset Allocation versus Target Allocation as of December 2010



Statistical Performance (net of fees)

Portfolio Characteristics	1 Year	3 Year	5 Year	10 Year
Annualized Return (gross of fees)	14.43%	0.32%	4.49%	5.53%
Annualized Return (net of fees)	14.12%	0.02%	4.20%	5.27%
Annualized Standard Deviation	10.70%	13.78%	11.23%	10.10%
Sharpe Ratio	1.31	-0.05	0.17	0.30
Excess Return	0.31%	0.29%	0.28%	0.26%
Beta	0.84	0.84	0.85	0.90
Correlation to Policy Benchmark	1.00	0.99	0.99	0.98

Commission Recapture

MERS requests that all domestic equity managers direct a target of 25% of commission trades with the State Street Global Markets LLC (SSGM) for the purpose of commission recapture. Brokerage transactions in the normal course of business should only be directed to this broker if in so doing the obligation to achieve best execution of the Fund's transactions is fulfilled. The SSGM program provides a network of brokers where trades can be executed. The recapture commissions are shared based on a contractual negotiated split of 90%/10% MERS/broker. Recapture dollars are used to offset the administrative, custodial, accounting and performance measurement costs incurred by the fund. For 2010, $162,986.19 was directed by equity managers to SSGM of which $93,113.40 was rebated to MERS.

Did You Know?

Governor Synder proclaimed March 17, 2011, as "Michigan Agriculture Day"

Investment Summary for Defined Benefit Plan, Retiree Health Funding Vehicle, Health Care Savings, and Investment Services Programs as of December 31, 2010

Type of Investment	Market Value
Fixed Income	
Domestic and International Fixed Income	$2,056,065,052
Total Fixed Income	**2,056,065,052**
Equities	
Domestic and International Stock	2,750,544,339
Total Equities	**2,750,544,339**
Private Equity & Commodities	
Commodities	342,763,111
Private Equity	628,232,728
Total Private Equity & Commodities	**970,995,839**
Real Estate	
Real Estate	319,082,003
Total Real Estate	**319,082,003**
Subtotal Investments	**6,096,687,233**
Cash Equivalents	
Cash Equivalents	181,949,080
Total Cash Equivalents	**181,949,080**
Subtotal Investments & Cash	**6,278,636,313**
Payables - Purchases of Investments	255,230,791
Receivables - Sale of Investments & Interest	(256,418,499)
Total Investments	**$6,277,448,605**

Note: Includes receivables and payables for sales and purchases of securities with settlement dates after December 31, 2010.

Reconciliation of Investments to Financial Statements

Investments on Financial Statements	$6,509,674,895
Less Defined Contribution Investments	(255,345,501)
Total Investments less Defined Contribution	**$6,254,329,394**
Total Investments from above chart	**$6,277,448,605**
Total Market Portfolio in Defined Contribution Portfolio	(19,159,411)
Bonds in Default	(2,841,574)
Small Unit Adjustments	(1,118,226)
Investments on Financial Statements less Defined Contribution	**$6,254,329,394**

EQUITY ASSET CLASS SUMMARY

As of December 31, 2010, the public equity portfolio had a market value of $2.65 billion, representing 42.3% of the Total Market Fund. Performance for the total equity portfolio was 18.81% net of fees.

Highlights

Several strategic changes took place within the public equity portfolio in fiscal year 2010. The Board approved the most recent asset allocation in July 2010 and we spent the rest of the year transitioning to the new allocation. As part of this process, we replaced several managers and some allocations were altered. Here are a few of the highlights:

- We decreased the allocation to active large cap equity managers with the belief that the efficiency in this area of the market makes it hard for active managers to add value over time. Instead we are choosing to invest with active managers in less efficient areas such as small, micro cap, and emerging market equities.
- For the second half of the year we maintained a strategic overweight to U.S. equities since we felt the economic growth of the U.S. economy would continue to surprise on the upside and exceed other developed countries.
- In the fourth quarter of 2010, we moved to the target allocation of 10% for international equity.
- Three managers were terminated, two were promoted from the emerging manager program, and two were hired for the emerging manager program.

Summary of Portfolio

MERS maintains a significant allocation to publicly traded shares of corporations around the world. Broad exposure to the public equity markets is paramount to achieving the Fund's stated objectives and delivering the actuarial rate of return of 8%. The public equity portfolio has a target allocation of 44.5% of the total fund. As of December 31, 2010, the portfolio includes domestic equity, international developed equity, and emerging and frontier markets equity. Exposure is achieved through portfolios diversified by geographic region, styles, sectors, and market capitalizations. Active management is used to take advantage of less efficient areas of the market, while passive management is deployed in more efficient areas, and used to reduce fees. Allocations are monitored in relation to asset class bands on an ongoing basis and rebalances take place if deemed appropriate. This portfolio is expected to perform well in periods of low to falling inflation and rising economic growth. It is also expected to provide ongoing income through dividend payments as well as downside protection in volatile markets.

Market Overview

The world's equity markets finished 2010 with a roar with every major index in positive territory. Fiscal year 2010 was a tale of two halves as equity markets struggled in the first half of the year but posted strong returns in the second half. When fears of a European sovereign debt crisis and a double dip in the U.S. surfaced, government support in the form of European bailouts and QE2 calmed these fears and set the stage for an impressive second half rally.

Domestic equities posted impressive returns with small cap equities leading the way. The Russell 2000 finished the year up 26.9% while the S&P was up 15.5%. The consumer discretionary, industrials, and materials sectors posted the strongest returns at 30.1%, 27.3%, 25.2%, respectively. Returns for other developed market countries were also strong as the MSCI EAFE Index returned 8.2% for the year. Returns trailed U.S. indices as a result of European debt fears and slower economic growth. Emerging market equities were the best performing asset class returning 18.9% for the year buoyed by strong economic growth and continual fund inflows. Across all geographic regions, growth stocks outpaced their value counterparts and small cap equities outperformed large cap equities.

It is tough to find consensus on what lies ahead for the markets. Some feel the global economy is poised to slow in the second half of 2011 citing worrisome developed country debt levels, inflation fears in China, continued high unemployment, and a housing market that appears to be headed for a double dip. However, corporate earnings continue to surprise on the upside and corporate balance sheets are in the best shape they have been in decades, providing continued fuel for an equity rally. One thing that is certain is market volatility is likely to persist as a sustainable economic recovery struggles to take hold.

Public Equity Performance as of December 31, 2010 (net of fees)

Portfolio Characteristics	1 Year	3 Year	5 Year	10 Year
Total Equity	18.81%	-2.79%	2.94%	4.33%
Russell 3000 Index	16.93	-2.01	2.74	2.16
Excess	**1.88**	**-0.78**	**0.20**	**2.17**
Domestic Equity	21.23	-1.27	2.74	4.18
Russell 3000	16.93	-2.01	2.74	2.16
Excess	**4.30**	**0.74**	**0.00**	**2.02**
International Equity	13.14	-5.97	3.63	4.25
MSCI ACWI ex. U.S.	11.60	-4.58	5.29	5.97
Excess	**1.54**	**-1.39**	**-1.66**	**-1.72**

Top Ten Equity Holdings as of December 31, 2010

Asset Description	Market Value	Percentage of Total Market Value
Apple	$39,534,566	0.63%
Microsoft Corporation	21,171,456	0.34
Oracle Corporation	19,979,572	0.32
Google	19,859,980	0.32
Goldman Sachs Group	16,527,773	0.26
Paccar	16,204,268	0.26
EMC Corporation	15,876,089	0.25
Altera Corporation	13,995,748	0.22
Exxon Mobil Corporation	13,863,552	0.22
WMS Industries	13,479,981	0.21

Note: A complete list of portfolio holdings is available upon request.

Public Equity – Investment Managers

Investment Manager	Style	Portfolio Market Value
External Investment Manager		
Blockrock	Frontier Markets Enhanced Index	$59,559,248
Acadian	International Small Cap	161,796,795
Blackrock	Global Macro Hedge Fund	29,735,640
Driehaus	All-Cap Global Growth	329,262,292
HEXAM	Emerging Markets	91,284,583
Hellman Jordan	All-Cap U.S. Core	26,308,081
Wellington	Large Cap U.S. Growth	377,857,066
BRC Investment Management	Large Cap U.S. 130/30	33,666,930
AMBS	Large Cap U.S. Value	27,931,188
C.S. McKee	Small Cap U.S. Core	248,106,425
Irving Magee	Small Cap U.S. Value	97,943,050
Kennedy	Small Cap U.S. Value	201,946,629
Wellington	Mid Cap U.S. Core	231,245,020
Seizert	SMID Cap U.S. Value	25,390,300
Other	N/A	757,336
Internal Investment Manager		
MERS S&P 400	S&P 400 Index	150,153,474
MERS S&P 500	S&P 500 Index	426,751,996
MERS S&P 600	S&P 600 Index	133,132,656
Total		**$2,652,828,709**

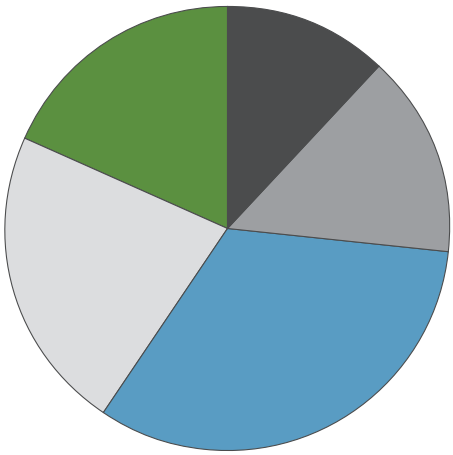
FIXED INCOME AND HIGH YIELD ASSET CLASS SUMMARY

As of December 31, 2010, the total fixed income portfolio had a market value of $2.05 billion representing 32.7% (fixed income of 26.7% and high yield of 6.0%) of the Total Market Fund. Performance for fixed income and high yield was 7.88% and 16.22% net of fees, respectively.

Fixed Income

Fixed income is the bedrock of the MERS Total Market Fund providing exposure to high quality fixed income instruments that create stable cash flow and liquidity to the overall portfolio. Total fixed income assets as of December 31, 2010, were $1.67 billion and were allocated into five strategies (see pie chart). Fixed Income provides meaningful diversification to the Total Market Fund covering a variety of different macroeconomic environments. Core fixed income tends to perform well in times of falling growth and stable inflation providing critical downside protection to the portfolio.

Fixed Income Allocation as of December 31, 2010



Enhanced Index (passive)	12.03%
Infrastructure (active)	14.83%
Core (active)	32.69%
Global (active)	22.36%
Emerging Market Debt (active)	18.09%

One result of the 2010 asset allocation study was the addition of emerging market debt as a sub-asset class within fixed income. MERS believes that emerging market debt is no longer a fad but a long term investment trend. This is evident by the fact that it has become a permanent player in the global fixed income investment universe. In fact, a number of broad market indices now have a dedicated allocation to the asset class.

Exposure to emerging market debt has historically been implemented via the "plus" portion of a core-plus portfolio and MERS is not unique in this regard. However, as MERS studied the asset class, it became clear that it needed to be a dedicated portfolio.

The case for a dedicated emerging market debt portfolio:

- Improving credit fundamentals
- Attractive reward risk profile
- Low correlations with both U.S. interest rate policy and credit products
- $1.9 trillion market – 2.3x U.S. high yield market
- EMD corporate market is the fastest growing fixed income market globally
- EM local currency is an inflation hedge to USD debt
- Approximately 55% of index is now investment grade

The MERS Board approved the Office of Investments recommendation of hiring Trust Company of the West (TCW) for a dedicated emerging market debt mandate. TCW was hired and funded in November of 2010.

Market Commentary

At the beginning of 2010, most investors were no longer worried about another "Great Depression," but instead, were focused on whether a perceived global recovery had legs that would lead us back to a sense of market normalcy. Unfortunately, economic headwinds (high unemployment, U.S. deficit, a struggling housing market, inflation fears, etc.) created numerous challenges for the Federal Reserve and policy makers. In fact, in its final meeting of the year, the FOMC announced that it was retaining the target for the federal funds rate in a range from 0 to 0.25%. The FOMC noted the interest rate policy reflected that growth is "insufficient to bring down unemployment" and inflation has "continued to trend lower."

The U.S. Treasury yield curve remained steep in 2010. Short-term rates remained anchored near historic lows in response to the Federal Reserve's zero interest rate policy. Yields on longer dated maturities initially declined due to global uncertainty and Federal Reserve policies. Ultimately, yields rebounded (prices dropped) late in the year due to investor concerns that economic growth would fuel inflation.

The U.S. credit markets had another solid year as corporate profits rebounded leading to improved fundamentals and credit quality.

Global fixed income markets, including emerging markets, were largely driven by the search for yield creating a divergence of performance between developed and emerging market countries. Generally speaking, the largest developed markets maintained low interest rate policies as a means to stimulate their respective domestic economies. These policies pushed fixed income investors toward higher interest rates offered by developing economies, sending debt for those regions higher for the year.

Fixed Income Performance as of December 31, 2010 (net of fees)

	1 Year	3 Year	5 Year	10 Year
MERS Fixed Income	7.88%	5.85%	6.05%	6.20%
BC Aggregate (Daily)	6.54	5.90	5.80	5.84
Excess	1.34	-0.05	0.25	0.36

Top Ten Fixed Income Holdings as of December 31, 2010

Asset Description	Market Value	Percentage of Total Market Value
United States Treasury 2.625% 11/15/2020	$95,395,894	1.53%
United States Treasury 1.25% 7/15/2020	40,019,136	0.64
United States Treasury 0.625% 7/31/2012	25,930,597	0.42
Fannie Mae 2.0% 12/30/2022	22,960,731	0.37
United States Treasury 0.5% 4/15/2015	22,783,292	0.37
United States Treasury 3.875% 8/15/2040	19,246,259	0.31
United States Treasury 3.125% 4/30/2017	18,987,851	0.30
United States Treasury 4.625% 10/31/2011	17,277,644	0.28
United States Treasury 2.125% 5/31/20/15	17,016,995	0.27
Swedish Government Bond (B0312GII8)	14,248,105	0.23

Note: A complete list of portfolio holdings is available upon request.

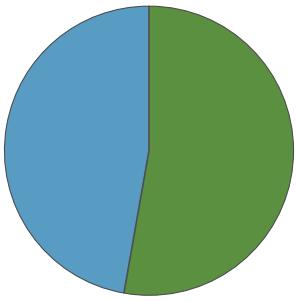
Fixed Income – Investment Managers

Investment Manager	Style	Portfolio Market Value
External Investment Manager		
BGI	Core Enhanced Index	$201,900,509
Credit Suisse	Infrastructure	248,692,775
C.S McKee	Core Fixed Income	276,324,555
First International Advisors	Global Bonds	375,241,662
Reams Asset Management	Core Fixed Income	272,331,858
TCW	Emerging Market Debt	303,648,506

High Yield

The MERS high yield allocation provides additional diversification to the Total Market Fund through allocations to domestic and global high yield, emerging markets, and inflation protected securities. Total high yield assets as of December 31, 2010, were $377,928,187 and were allocated into two strategies (see pie chart). This strategy employs opportunistic mandates that allow for duration bets versus benchmarks. A blended approach is expected to deliver returns in excess of U.S. high yield benchmarks with less volatility.

High Yield Allocation as of December 31, 2010



Global High Yield (active)	52.97%
Loan Credit Fund (active)	47.03%

Market Commentary

Risky assets rebounded late in 2010 and finished the year on a high note. The strength was derived from the Federal Reserve's QE2 announcement and President Obama's hint at tax cut extensions. In addition, economic data rebounded from a summer lull, suggesting modest growth. While Treasury bonds ended the year with a positive return, rates were notably higher in the fourth quarter (+74 bps), which ironically confirmed QE might be working by driving future inflation expectations higher. As a result, floating rate debt such as leveraged loans performed well and kept pace with high yield bonds.

High Yield Performance as of December 31, 2010 (net of fees)

	1 Year	3 Year	5 Year	10 Year
High Yield	16.22%	1.87%	4.42%	
BofAML High Yield Master II (Daily)	15.19	10.12	8.80	8.60
Excess	1.03	-8.25	-4.38	

High Yield – Investment Managers

Investment Manager	Style	Portfolio Market Value
External Investment Manager		
Stone Tower	Loan Credit Fund	$177,739,952
Stone Harbor	High Yield/EMD/Tips	200,185,235

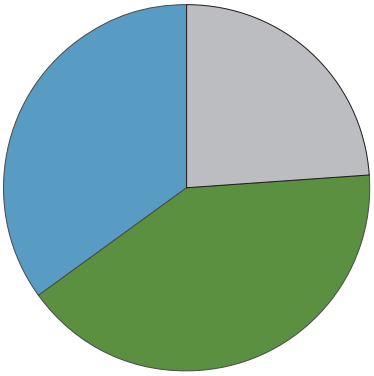
ALTERNATIVE ASSET CLASS SUMMARY

As of December 31, 2010, the alternative portfolio had a market value of $1.29 billion representing 20.6% (real estate of 5.10%, commodities of 5.50% and private equity of 10.00%) of the Total Market Fund. Performance for real estate, commodities and private equity was 4.19%, 15.04% and 15.52% net of fees, respectively.

Real Estate

MERS Real Estate target allocation represents 7% of the total plan and is diversified among private property partnerships, global real estate investment trusts (REITs), and timber partnerships. The allocation provides diversification, consistent income, and uncorrelated returns to the Total Market Fund.

MERS Real Estate



Commodities

The MERS commodities target allocation represents 5% of the Total Market Fund. Commodities exhibit low correlations to most traditional asset classes and therefore behave differently during market cycles. Unlike stocks and bonds, commodities are expected to perform well during periods of inflation creating a natural hedge in the portfolio. Exposure to the commodity markets is obtained through an enhanced swap agreement with Cargill. A dedicated collateral pool is set aside to provide 100% coverage for the commodity allocation and maintain a credit rating of AAA.

Private Equity

MERS private equity target allocation represents 7% of the total plan and adds diversification to the overall equity allocation of the Total Market Fund. Investments in private equity include U.S and international, and venture capital, buyout, and special situation funds.

Alternative Performance as of December, 31, 2010

	1 Year	3 Year	5 Year	10 Year
MERS Real Estate	4.19%	-7.45%	0.58%	6.96%
MERS Custom Real Estate Benchmark	7.28	-0.73	5.95	8.56
Excess Return	-3.09	-6.72	-5.37	-1.61
MERS Commodities	15.04	-6.88		
Goldman Sachs Commodity Index	9.02	-12.84	-5.70	1.77
Excess Return	6.02	5.96		
MERS Private Equity	15.52	1.44	5.96	
Russell 2000	26.85	2.22	4.47	6.33
Excess Return	-11.33	-0.79	1.49	

Alternatives – External Investment Managers

Investment Manager	Style	Portfolio Market Value
Real Estate		
Townsend	Private Real Estate	$75,597,844
Urdang	Global REIT	132,839,295
Hancock	Timber	110,644,864
Commodities		
Cargill	Enhanced Index	314,056,961
Mt. Lucas	Commodity Hedge Fund	28,706,150
Private Equity		
Credit Suisse	Fund of Fund & Co Investments	594,414,259
Mesirow Capital Partners	Fund of Fund	33,818,469

Schedule of Investment Fees – as of December 31, 2010

Investment Managers	Average Assets Under Management	Annual Fee	Average Basis Points
Acadian Asset Management	$161,986,056	$711,921	43.95
AMBS Investment	27,944,481	50,462	18.06
Barclays Global Investors- Core Active	201,900,509	236,988	11.74
Barclays Global Investors- Frontier Markets	59,667,508	404,645	67.82
BRC Investment Management	33,687,192	77,337	22.96
Credit Suisse Customized Infrastructure	248,692,774	2,656,307	106.81
Credit Suisse Private Equity Fund	628,232,728	4,782,645	76.13
C.S. McKee	248,345,883	910,388	36.66
C.S. McKee- Fixed Income	276,432,465	421,994	15.27
Delaware Investment Advisors	318,045,182	470,612	14.80
Driehaus Global Growth	329,499,943	540,375	16.40
First International Advisors	375,458,309	830,426	22.12
Hellman Jordan	26,320,072	12,518	4.76
HEXAM	91,441,517	512,624	56.06
Irving Magee	97,989,210	131,409	13.41
Kennedy Capital Management	202,148,373	796,987	39.43
Mount Lucas	28,706,147	11,473	4.00
Reams Asset Management	272,358,141	276,266	10.14
Seizert Capital	25,390,299	6,899	2.72
Stone Harbor	200,348,830	679,069	33.89
Urdang Investment Management	133,009,459	605,922	45.55
Wellington Management	378,081,449	792,238	20.95
Wellington Management- Mid Cap	231,536,288	974,893	42.11
The Townsend Group	75,597,844	172,337	22.80
Total Investment Manager Fees	$4,672,820,659	$17,066,735	36.52
Investment Custodian			
State Street Bank and Trust		1,026,013	
Investment Performance Measurement Consultant			
State Street Bank and Trust		102,000	
Securities Lending Agent			
State Street Bank and Trust		823,457	
Total Investment Fees		$19,018,205	

Schedule of Investment Commissions as of December 31, 2010

Brokerage Firm	Shares Traded	Total Dollars	Commission/Share
UBS Securities, LLC	44,689,261	$20,060	0.0004
Morgan Keegan & Co.	38,584,676	9,289	0.0002
RBC Capital Markets	36,940,497	34,252	0.0009
Stifel Nicolaus & Co.	21,074,080	7,412	0.0004
National Financial Services Corp	20,050,066	8,066	0.0004
HSBC Securities	17,762,524	331	0.0000
Jefferies and Co.	13,257,709	26,829	0.0020
Merrill Lynch, Pierce, Fenner, and Smith	12,927,711	114,916	0.0089
Cantor Fitzgerald & Company	11,729,446	184,685	0.0157
Citi Group Global Markets	11,659,960	1,266	0.0001
Scott & Stringfellow	10,977,046	5,555	0.0005
JP Morgan	9,082,950	46,403	0.0051
Goldman Sachs & Company	6,268,077	13,898	0.0022
BMO Capital Markets	5,483,010	19,046	0.0035
Keybanc Capital Markets	5,393,565	7,581	0.0014
Barclays Capital	5,354,661	46,356	0.0087
SG Securities	4,178,624	3,435	0.0008
Piper Jaffray	3,899,398	3,263	0.0008
Credit Research and Trading LLC	3,681,950	892	0.0002
Wedbush Morgan Securities	3,292,499	93,627	0.0284
William Smith Securities	2,924,771	88,806	0.0304
Sterne, Agee, and Leach	2,917,168	10,501	0.0036
Stephens	2,828,442	16,167	0.0057
Knight Securities	2,546,118	60,908	0.0239
Weeden & Company	2,532,593	52,499	0.0207
Subtotal (25 Largest)	300,036,802	876,043	0.0029
Remaining Total	60,143,698	1,055,799	0.0176
Total Commissions	**360,180,500**	**$1,931,842**	**0.0054**

Securities Lending

In 2010, MERS earned $3,294,781 through its securities lending program managed by State Street.

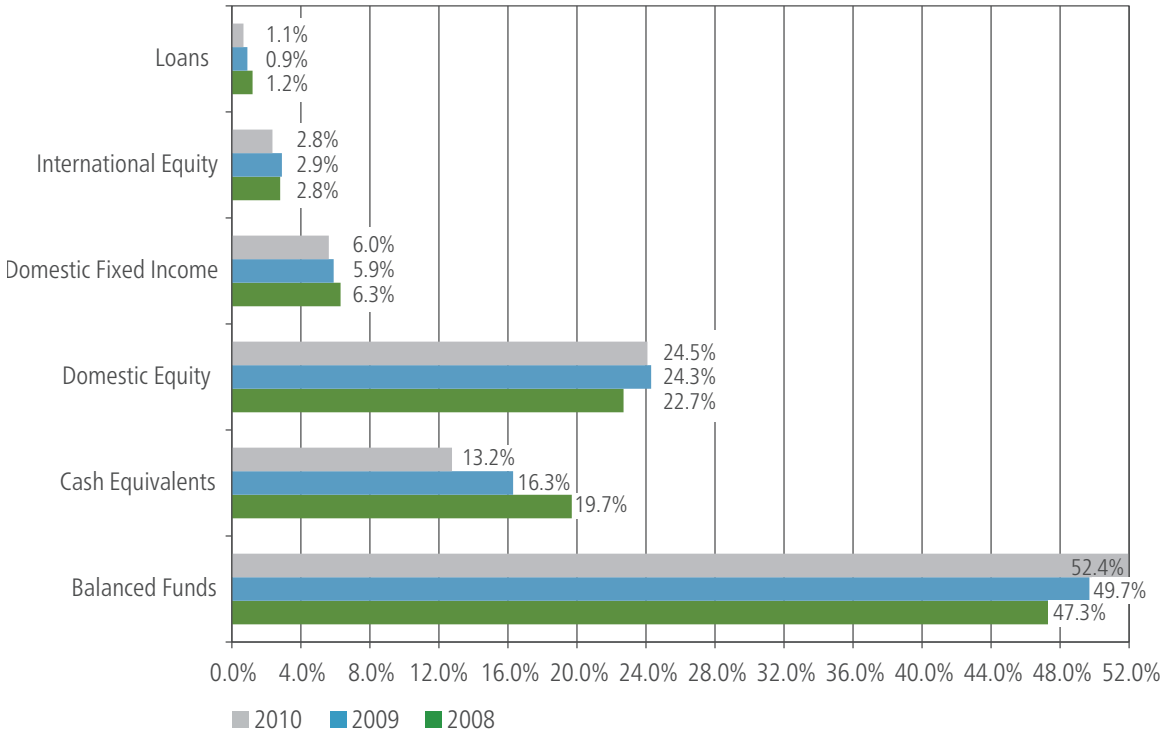
December 2010	US Corporate Bond & Equity	US Govt.	Non-US Equity	Non-US Fixed Income	Reinvested Earnings	Other Earnings	Monthly Earnings
First Quarter	$751,894	$114,845	$28,299	$6,071	$ -	$ -	$901,109
Second Quarter	627,791	74,711	144,173	7,270	-	-	853,945
Third Quarter	796,085	109,648	28,667	5,654	-	4,527	944,581
Fourth Quarter	473,544	89,929	20,738	5,689	-	5,246	595,146
Total Earnings	$2,649,314	$389,133	$221,877	$24,684	-	$9,773	$3,294,781

B. Defined Contribution Plan

Investment Activity

The MERS Defined Contribution Plan became operative on July 8, 1997, under Section 401(a) of the Internal Revenue Code. This plan is available for adoption by all member municipalities, and is an alternative option to MERS Defined Benefit Plan. As of December 31, 2010, the Defined Contribution Plan had net assets of $298 million and 8,636 members. Each member is responsible for directing the investments of their accumulated account balance. Members receive investment performance information from MERS third-party administrator. MERS allows its Defined Contribution participants to invest in the Total Market Fund, Established Market Fund, Diversified Bond Fund, and Short-Term Managed Income Fund.

Asset Allocation of Defined Contribution Plan as of December 31, 2010



Investment Options

MERS offers the following investment options for the Defined Contribution Plan through a third-party administrator:

Plus Fund And Money Market

The Plus Fund consists primarily of portfolios of investment contracts purchased from financial institutions and accordingly, maintains a stable capital value in the absence of credit default. The Cash Management Money Market offers a liquid position that seeks to maintain principal while earning a short-term yield.

Bond Funds

Bond funds offer investments into various bond types:

- The MERS Short-Term Managed Income Fund offers the short-term managed cash returns from the MERS Defined Benefit portfolio.
- The MERS Diversified Bond Fund offers a global bond fund from MERS Defined Benefit pension portfolio; Inflation Protected Securities Fund offers investment into Government Securities.
- PIMCO Total Return Fund and the Core Bond Index Fund offer diversified fixed income holdings; and the PIMCO High Yield fund offers lower grade but higher yielding fixed income positions.

Equity Funds

Equity funds actively manage funds invested in both domestic and international equities. Included in this category are:

- Aggressive Opportunities Fund, International Fund, Growth Fund, Growth and Income Fund, Equity Income Fund, Fidelity Diversified International Fund, American Century Value Fund, Ave Maria Fund, Lord Abbott Large Company Value Fund, Legg Mason Value Fund, Calvert Social Investment Fund, Fidelity ContraFund, Fidelity Magellan Fund, Goldman Sachs Mid Cap Value Fund, Third Avenue Value Fund, Rainier Small/Mid Cap Equity Fund, T. Rowe Price Small Cap Stock Fund, Royce Premier Fund, Fidelity Small Cap Retirement Fund, and the American Century Real Estate Investment Trust.

Equity Index Funds

Equity index funds are comprised of:

- Overseas Equity Index Fund
- Mid/Small Company Index Fund, Broad Market Index Fund
- 500 Stock Index Fund

Balanced Funds

Balanced funds are comprised of managed allocation styles of stocks, bonds, cash, and/or other asset classes. A fund manager decides when and what proportion to move between them. Included are:

- Fidelity Puritan Fund
- Asset Allocation Fund
- MERS Established Market Fund
- MERS Total Market Fund

Model Portfolio Funds

Model portfolio funds consist of five funds invested in actively managed funds, index funds, and investment contracts in varying proportions. They allow the investor to choose one investment vehicle to provide the level of diversification that best meets their risk tolerance and investment objectives. Included in descending order of market risk:

- All-Equity Growth Fund
- Long-Term Growth Fund
- Traditional Growth Fund
- Conservative Growth Fund
- Savings-Oriented Fund

Target Date Funds

Target date funds are a series of funds or portfolios designed for retirement dates at 5-10 year intervals. These broad asset-allocation portfolios are designed to seek high returns when retirement is many years off, and to gradually moderate risk over time.

Target date investing allows investors the opportunity to select one fully diversified fund designed to meet their individual time horizons and risk tolerance. This strategy can be accomplished through the allocation of individual stocks, bonds and cash, or, by combining existing mutual funds, creating a "fund of funds." Once the asset mix is established, it will automatically rebalance at a predetermined future date based on a presumed age.

C. Hybrid Plan

MERS Hybrid Plan offers the stability and security of a Defined Benefit Plan with the flexibility and investment choice of a Defined Contribution Plan. The Defined Benefit component (Part I) is employer funded, with benefit multipliers of 1.0%, 1.25%, and 1.5%. The Defined Contribution component (Part II) is a combination of employer and employee contributions that are invested in mutual funds selected by the individual participant. To view investment activity on the Defined Benefit component, see part A of the Investments Section and to view investment activity on the Defined Contribution component, see part B of the Investments Section.

D. MERS Health Care Savings Program and MERS Retiree Health Funding Vehicle

The MERS Health Care Savings Program and the Retiree Health Funding Vehicle are investment programs, meaning contributions are grown over time, through a choice of four Core Investment Options. MERS values a disciplined, diversified approach to investing, and must also follow Michigan state law and established standards of diligence, with strict oversight and management. The funds are professionally managed by a dedicated team of experienced investment professionals and support staff, and are responsible for monitoring all investment activity.

The core funds, shown on next pages, are as follows:

- MERS Total Market Fund
- MERS Established Market Fund
- MERS Diversified Bond Fund
- MERS Short-Term Managed Income Fund

MERS Total Market Fund

MERS Total Market Fund is a fully diversified portfolio combining traditional with alternative asset classes. The objective is to provide growth and income while minimizing the volatility of the capital markets

Fund Summary – Assets as of December 31, 2010: $6.2 billion

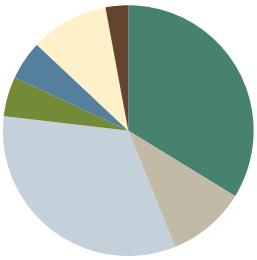
	1 Year	3 Year	5 Year	10 Year
MERS Total Market Fund	13.94%	0.10%	4.24%	5.29%
Custom Benchmark	13.65	1.16	4.83	5.22
Excess Return	**0.29**	**-1.06**	**-0.59**	**0.07**

Returns are presented Net of Investment Management Expenses only as of December 31, 2010. Returns for periods greater than one year are annualized.

Performance information prior to December 31, 2007, is linked with the returns of the MERS Defined Benefit Portfolio as the MERS Total Market Fund uses the same strategy. The returns from the MERS Defined Benefit Portfolio are Net of Investment Management Expenses only.

Past performance is no guarantee of future results. Current performance may be higher or lower. Investment returns and values will fluctuate, and shares when redeemed, may be worth more or less than their original cost. Please visit the MERS website at *www.mersofmich.com* for more recent performance information.

Asset Allocation as of December 31, 2010



U.S. Stock	33.75%
International Stock	10.16%
Bonds	32.94%
Real Estate	5.13%
Commodities	5.03%
Private Equity	10.08%
Cash	2.91%

Did You Know?

Michigan's agriculture is only second in diversity to California

MERS Established Market Fund

MERS Established Market Fund seeks to provide long-term growth of capital and income through a diversified mix of stocks and bonds. The objective is to outperform the traditional 60/40 mix of stocks to bonds (excludes private equity, real estate, and commodities).

Fund Summary – Assets as of December 31, 2010: $4.3 billion

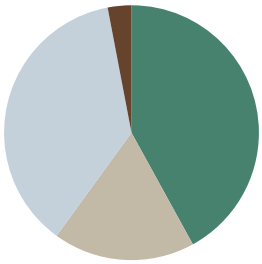
	1 Year	3 Year	5 Year	10 Year
MERS Established Market Fund	15.46%	3.18%	6.11%	7.55%
Custom Benchmark*	13.25	1.71	4.38	4.01
Excess Return	**2.21**	**1.47**	**1.73**	**3.54**

Returns are presented Net of Investment Management Expenses only as of December 31, 2010. Returns for periods greater than one year are annualized.

Return information prior to December 2, 2008, is linked with the component returns of the MERS Defined Benefit Portfolio as the MERS Established Market Fund is broadly the same strategy. The returns from the MERS Defined Benefit Portfolio are Net of Investment Management Expenses only.

Past performance is no guarantee of future results. Current performance may be higher or lower. Investment returns and values will fluctuate, and shares when redeemed, may be worth more or less than their original cost. Please visit the MERS website at *www.mersofmich.com* for more recent performance information.

Asset Allocation as of December 31, 2010



U.S. Stocks	42.00%
International Equity	18.00%
Bonds	37.00%
Cash	3.00%

Did You Know?

Production agriculture, food processors and related business employ about one million Michiganians

MERS Diversified Bond Fund

MERS Diversified Bond Fund seeks current income and growth of capital by investing in a wide spectrum of fixed income securities both in the United States and abroad. The objective is to outperform the Barclays Capital U.S. Aggregate Bond Index.

Fund Summary – Assets as of December 31, 2010: $1.4 billion

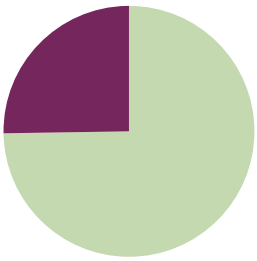
	1 Year	3 Year	5 Year	10 Year
MERS Diversified Bond Fund	8.31%	6.97%	6.75%	6.55%
Barclays Capital U.S. Aggregate	6.56	5.91	5.80	5.84
Excess Return	**1.75**	**1.06**	**0.95**	**0.71**

Returns are presented Net of Investment Management Expenses only as of December 31, 2010. Returns for periods greater than one year are annualized.

Return information prior to September 9, 2008, is linked with the component returns of the MERS Defined Benefit Portfolio as the MERS Diversified Bond Fund is broadly the same strategy. The returns from the MERS Defined Benefit Portfolio are Net of Investment Management Expenses only.

Past performance is no guarantee of future results. Current performance may be higher or lower. Investment returns and values will fluctuate, and shares when redeemed, may be worth more or less than their original cost. Please visit the MERS website at *www.mersofmich.com* for more recent performance information.

Asset Allocation as of December 31, 2010



Did You Know?

Average farm size is approximately 179 acres

MERS Short Term Managed Income Fund

MERS Short-Term Managed Income Fund seeks to obtain the maximum current income, consistent with preservation of capital and liquidity that is available through investments in investment-grade commercial paper, corporate bonds, and U.S. agencies. The objective is to outperform the Barclays Capital U.S. Treasury 1-3 Year Index.

Fund Summary – Assets as of December 31, 2010: $0.18 billion

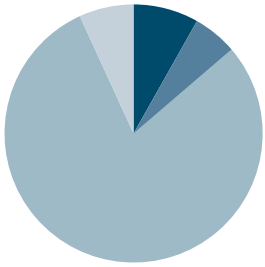
	1 Year	3 Year	5 Year	10 Year
MERS Short-Term Managed Income Fund	1.95%	3.69%	5.84%	6.65%
Barclays Capital U.S. Treasury 1-3 Year	2.39	3.26	4.19	3.94
Excess Return	**-0.44**	**0.43**	**1.65**	**2.71**

Returns are presented Net of Investment Management Expenses only as of December 31, 2010. Returns for periods greater than one year are annualized.

Return information prior to August 21, 2008, is linked with the component returns of the MERS Defined Benefit Portfolio as the MERS Short-Term Managed Income Fund is broadly the same strategy. The returns from the MERS Defined Benefit Portfolio are Net of Investment Management Expenses only.

Past performance is no guarantee of future results. Current performance may be higher or lower. Investment returns and values will fluctuate, and shares when redeemed, may be worth more or less than their original cost. Please visit the MERS website at *www.mersofmich.com* for more recent performance information.

Asset Allocation as of December 31, 2010



E. MERS Investment Services Program

The Investment Services Program provides municipalities with a non-membership access to the MERS Total Market Fund. Employers benefit from a professionally managed fund, economies of scale and lower administrative fees, while still maintaining local control of administration. To view investment activity on the MERS Total Market Fund, see part A of the Investments Section.