

BUILDING SUCCESS TOGETHER

COMPREHENSIVE ANNUAL FINANCIAL REPORT

FOR THE FISCAL
YEAR ENDED

12.31.2012

MUNICIPAL EMPLOYEES' RETIREMENT
SYSTEM OF MICHIGAN



ABOUT MERS

The Municipal Employees' Retirement System (MERS) of Michigan exists to provide quality retirement and related services with cost-effective plan administration for members and beneficiaries. We are an independent public nonprofit organization that has partnered with Michigan municipal organizations for more than 65 years, helping them deliver on their promise of a retirement for their employees.

BUILDING SUCCESS TOGETHER

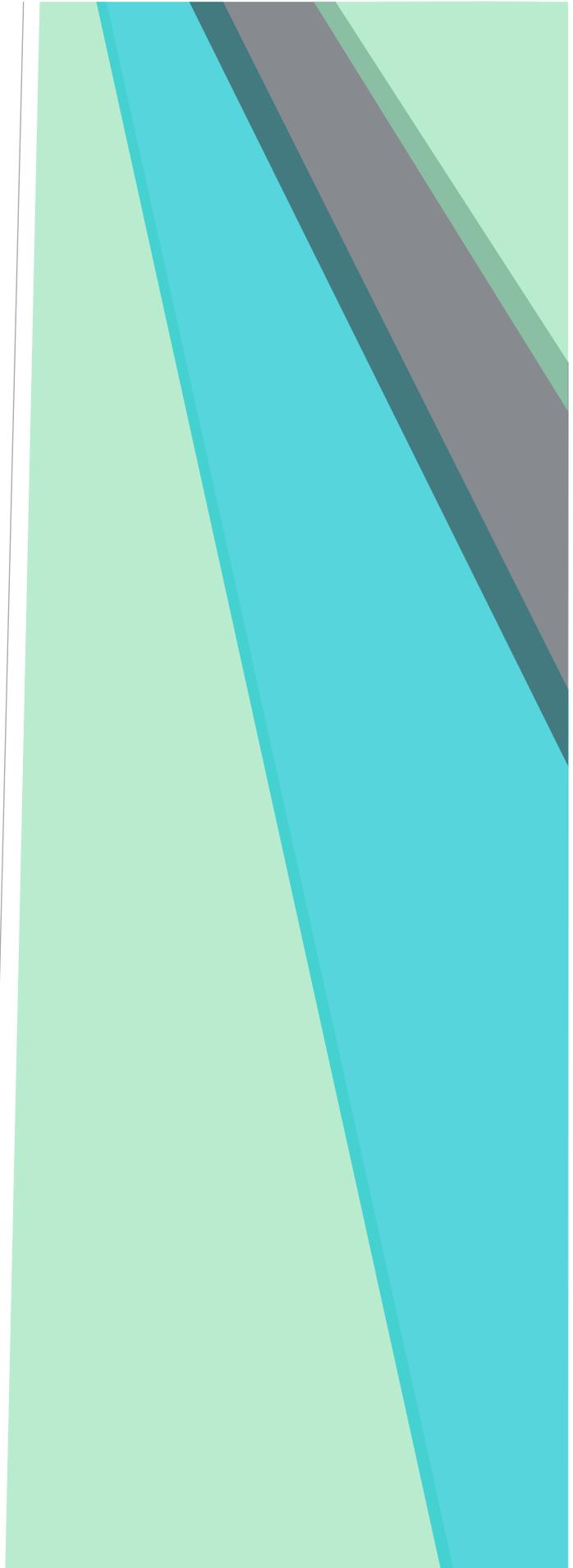
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INTRODUCTORY SECTION

A Foundation of Success

Our priority is building on our partnership with our municipalities, and by working together, we all become stronger. We are dedicated to building on that partnership together, through the foundational principles that guide our System.

2012 ACHIEVEMENTS



Certificate of Achievement for Excellence in Financial Reporting

MERS received the Certificate of Achievement for Excellence in Financial Reporting from the Government Finance Officers Association for the December 31, 2011 Comprehensive Annual Financial Report. This marks the 24th consecutive year MERS has received this honor.

Public Pension Standards Award in 2012

MERS also received the Public Pension Coordinating Council (PPCC), Public Pension Standards Award in 2012, in recognition of meeting the professional standards for plan design and administration as set forth in the Public Pension Standards. This award is presented by the PPCC, a confederation of the National Association of State Retirement Administrators (NASRA), the National Conference on Public Employee Retirement Systems (NCPERS), and the National Council on Teacher Retirement (NCTR).



Letter of Transmittal, May 8, 2013

Dear Board Members:

We are pleased to submit the Comprehensive Annual Financial Report (CAFR) for the Municipal Employees' Retirement System (MERS) of Michigan for the fiscal year ending December 31, 2012.

"Building Success Together" is the theme for this year's publication. As you will see throughout this report, our priority is building on our partnership with our municipalities. By working together, we all become stronger.

As a measure of that strength, our retirement trust fund at year-end held \$7.7 billion, the highest amount in our history. This makes us more cost-effective for the nearly 800 municipal organizations we partner with, and a stronger System for the almost 100,000 public employees and retirees we serve throughout Michigan.

We are dedicated to building on that success together, through the foundational principles that guide our System:

A Tradition of Service

MERS was created in 1945 by the Michigan Legislature as a statewide voluntary organization. We provide system administration and are an investment vehicle for local governmental entities throughout Michigan, including cities, counties, townships, medical care facilities, road commissions, authorities, villages, and tribal governments.

In 1996, the Michigan Legislature separated MERS from state government. MERS started its independent status with just under 500 employer members. Today, we partner with nearly 800 local governments all across the state. MERS offers retirement options including the MERS Defined Benefit Plan, MERS Defined Contribution Plan and MERS Hybrid

Plan (a combination of defined benefit and defined contribution). MERS also offers a menu of benefit provisions through a variety of trusts, which may be adopted by member employers to create benefit plans or fund benefits for their employees. Each employer has a trust account in the System, and one municipality's assets are never used to fund the pension obligations of another. All trust funds are co-mingled for investment purposes only, but MERS maintains separate accounting records for each municipality. The MERS Retirement Board serves as the fiduciary of the funds and has oversight responsibilities for the System.

A Commitment to Accountability

Michigan law requires the Retirement Board to prepare an annual report in accordance with U.S. Generally Accepted Accounting Principles (GAAP). This annual report provides financial information to meet that requirement. The MERS management team, under the oversight of the Retirement Board, is responsible for the preparation, integrity, and fairness of the financial statements and other information presented in this report. As a part of our financial statement process, all necessary internal controls are identified and in place to ensure that transactions are authorized, assets safeguarded, and all supporting records are properly retained and managed. We have an Internal Auditor on staff to help ensure we meet high standards for internal control.

Michigan Law also requires the Retirement Board to arrange for an annual audit of the MERS financial statements. Andrews Hooper Pavlik PLC, MERS external auditor, conducted an independent audit of the financial statements in accordance with U.S. Generally Accepted Auditing Standards and Governmental Auditing Standards. This audit

is described in the Independent Auditor's Report in the Financial Section that follows this letter. MERS management provides the external auditors with unrestricted access to records and staff.

This CAFR is divided into five sections: Introductory, Financial, Investment, Actuarial, and Statistical. The Introductory Section outlines the System's services and structure; the Financial Section contains the Management's Discussion and Analysis (MD&A), which is the MERS management team's narrative and overview of the financial statements. This Transmittal Letter is designed to supplement and complement the MD&A. The two documents should be read together to get a thorough overview of MERS' financial condition. The Investment Section reports investment activities and performance information; the Actuarial Section contains the actuarial assumptions and methods, as well as the Actuary's Certification Letter. The Statistical Section provides various schedules on member data and 10-year trends.

Prudent Investment

The world financial markets improved significantly during the year providing positive returns for the year ending December 31, 2012. The MERS portfolio earned a gross return of 11.39%, and placed MERS in the top quartile for performance for the last 10-year period according to the State Street Universe of public funds. Information regarding the investment managers and returns are found in the Investments Section. This strong performance in the financial markets, plus a significant inflow of assets from new municipalities joining MERS, increased the size of the MERS fund from \$6.6 billion to \$7.7 billion, an increase of 17%.

Many municipal governments are providing more participant directed account benefits for their employees, and MERS has

innovated and expanded our benefit offerings in recent years to meet our members' needs. Our menu of participant directed plans includes: the MERS Defined Contribution Plan, 457 Supplemental Retirement Program, and Health Care Saving Program. These programs are designed to help members take an active role in planning for the future, with invested accounts they manage. In 2012, the assets in these plans grew by \$84 million to \$450 million in total assets, a growth rate of 23% for the year.

“Building Success Together” is the theme for this year's publication. As you will see throughout this report, our priority is building on our partnership with our municipalities. By working together, we all become stronger.”

MERS also offers employer funding vehicle programs, the Retiree Health Funding Vehicle and Investment Services Program, innovative ways to help our member municipalities pre-fund benefit liability by providing access to MERS investments. These programs also experienced excellent growth in 2012, with assets growing by \$103 million to \$413 million in total funds, a growth rate of 33% for the year.

A Devotion to Advocacy

There were several new statutes passed by the Michigan Legislature in 2012 and signed into law by the Governor that impact public pension funds like MERS or our municipal employers, members and retirees. We have actively advocated on behalf of our members on legislation, to share their voice with local and federal legislators. Some of the legislation that impacted our members in 2012 includes:

Public Act 347 established new investment guidelines for public pension funds, generally

allowing state and local government pension funds more flexibility in selecting global funds and alternative investment strategies. The changes will increase MERS' ability to shift investments to maximize returns and increase the performance of the investment pool.

Public Acts 466, 506 and 507, generally known as the "Road Commission Best Practice Bills," provide requirements for local governments receiving road-funding monies. With these new acts, most local governments will need to implement certain pension reforms, including defined benefit pension multiplier reductions and changes in calculating final average compensation for pension benefits, or comply with the health insurance reforms in Public Act 152 of 2011, the Publicly Funded Health Insurance Contribution Act. It is important to stress that an entity has the option to choose between the two reform options and does not need to comply with both. We offer a number of pension and health care products designed to help municipal organizations meet the requirements of the new law.

Public Act 436 is the state's new emergency manager law. The new law allows additional local government involvement in cases where the State appoints an emergency manager to oversee a financially challenged municipality. Under the law, a Chapter 9 bankruptcy filing is also an option available to seriously troubled local governments. MERS offers municipalities a number of options to help reduce pension costs and help limit the amount of unfunded liability exposure.

Public Act 597 offers a partial income tax exemption for public pension retirees who are not eligible to receive Social Security Benefits. The amount of the exemption is based on the age of the retiree. A chart showing the tax impact on retirees is available on our website.

At the federal level, we have been actively involved in shaping the new GASB (Government Accounting Standards Board) financial reporting standards. Standards No. 67 and 68 detail new financial reporting

standards for pension plans and the municipal governments that participate in them. MERS representatives have publicly testified before the GASB, submitted written testimony, and served as a field tester for the new standards. In December 2012, the GASB appointed a 17-person national Pension Accounting & Financial Reporting Implementation Guide Advisory Committee. A MERS staff member was appointed to the committee and will continue to be active in helping our municipalities and their auditors implement the new standards.

Actuarial Funding Update

A measure of a municipality's funding progress is the ratio of its actuarial assets to actuarial accrued liabilities. Using this measure, most MERS municipalities remain well funded and many are very well funded. The most recent MERS actuarial valuation is as of December 31, 2011. On that date, the average funding ratio of all 706 individual MERS municipalities was 81%. This includes:

- 107 municipalities (15% of all Defined Benefit Plan and Hybrid Plan municipalities in MERS) funded at 100% or higher
- 313 municipalities (44% of all municipalities) funded at 80% or higher.
- 491 municipalities (70% of all municipalities) funded at 70% or higher.

Key 2012 Initiatives and Highlights

We continue to build success by focusing our initiatives in two key areas: reducing costs for our members and reducing the costs of the System.

With the goal of being more efficient and providing excellent service the Information Technology (IT) department worked in a number of key areas to improve their operation. They implemented several changes in 2012 and will continue with more into 2013, all with the goal of strengthening service to our members. Much like our municipal members, we continue to look at ways to reduce our operating costs and keep them as low as possible for our

members. This allows us to maximize their invested funds. In 2012, we were able to reduce our planned administrative costs by \$1.5 million. We've improved efficiencies elsewhere, as well. The MERS Service Center handled nearly 40,000 member calls and replied to more than 3,600 email inquiries from our employers and participants in 2012. With our continued focus on Service Excellence, nearly 80% of calls that come into the Service Center are resolved at the first point of contact.

Standards of Excellence

We continually strive to keep our standards at the highest level to ensure stability as a leader among our peers. We are honored that for the 24th consecutive year, the Government Finance Officers Association (GFOA) awarded MERS its Certificate of Achievement for Excellence in Financial Reporting award for our 2011 Comprehensive Annual Financial Report. This report must satisfy both generally accepted accounting principles and applicable legal requirements. The MERS Summary Annual Financial Report (a reader-friendly, condensed version of the CAFR) is an easy-to-understand financial summary of our operations. We also received the GFOA award for this report.

A complete copy of the CAFR is provided to the Governor, the members of both State House and Senate, and the Office of the State

Treasurer, as required by law. The CAFR and Summary Report are available on our website.

Acknowledgements

We are very grateful to our Board members for your tireless dedication that makes it possible for MERS to continue "Building Success Together" with our employers, members and retirees. Your conscientious oversight and diligence of our system is exemplary. On behalf of all MERS members, thank you for your dedication to public service. We also express our deep gratitude to the entire MERS staff for their hard work and dedication to ensure the successful operation of MERS including the completion of the 2012 Annual Audit and Comprehensive Annual Financial Report two months ahead of prior years. Our staff uses innovation, skill and a commitment to service every day to ensure the security of a retirement plan for all our members. Keeping MERS running as a strong organization also requires outstanding organizations and advisors who work in partnership with MERS to ensure our continued success. We also thank these talented firms and individuals for their work on our members' behalf.

Respectfully submitted,

Chris DeRose, Chief Executive Officer

Leon E. Hank, CPA, Chief Financial Officer



Letter from the Chairperson, May 8, 2013

Dear Board Members:

On behalf of the MERS Retirement Board, it is my pleasure to present the 67th Comprehensive Annual Financial Report (CAFR) of the Municipal Employees' Retirement System (MERS) of Michigan for the fiscal year ended December 31, 2012. This financial report provides information on the status of our Retirement System.

“The most important decision you make as a Retirement Board is to select our Chief Executive Officer to run MERS day-to-day. I am very pleased to highlight this year that we have hired an exceptionally seasoned CEO, Mr. Chris DeRose, for this challenge.”

The 2012 MERS Annual Meeting was held at the Amway Grand Plaza Hotel in Grand Rapids with a great turnout of member delegates, guests and staff. During the business meeting, the delegates duly elected Mr. Philip LaJoy, Canton Township Chief Administrator, and Ms. Lori Newberg, Ingham County Employee Services Coordinator, each to a three-year term on the Board beginning January 1, 2013. Mr. LaJoy will serve as the officer member and Ms. Newburg as the employee member. At the January 2013 Board meeting, the Board appointed Mr. John Ogden, retired City of Port Huron Finance Director, to a three-year term as the retiree representative on the Board. In addition, Mr. Michael Gilmore was appointed as a public professional member of the MERS Board, taking the seat vacated by Bruce Johnson. He is Director of Investment

Management for Greene Wealth Management in East Lansing. The Board is delighted to have these fine individuals serve the System and I extend my sincere congratulations to each of them. In addition, at the January 2013 Board meeting, Mr. Michael Brown, Barry County Administrator, was elected to serve as the chairperson, and Ms. Sally Dreves,

Grand Traverse County Human Resources Technician, was elected as chairperson pro tem.

The most important decision you make as a Retirement Board is to select our Chief Executive Officer to run MERS day-to-day. I am very pleased to highlight this year that we have hired an exceptionally seasoned CEO, Mr. Chris DeRose, for this challenge. We are indeed fortunate to have Chris at the helm, given his extensive experience in running two other large pension funds, his executive skills in both the government

and private sector, and his passion for public service. As MERS positions itself to become an even stronger partner to our current and future members, we will benefit from Chris' leadership and guidance.

As a Retirement Board, the integrity of our investment process is of utmost concern to us, especially with the global market turmoil. In the past year, the world and U.S. economies were marked by considerable volatility with the ongoing unrest in the Middle East, the U.S. presidential election, the fiscal cliff and European monetary challenges. Despite the instability, MERS had a very good return of 11.39% in its portfolio for the year. Contributing factors included low interest rates, corporate earnings increases, rising auto sales, and the housing market slowly coming back. Each

year the Board reviews the MERS Investment Policy along with the Investment Management Plan. The goal is to assure we meet the proper risk targets and to preserve and maximize the long-term growth of the System's assets. Every five years we also complete a full asset allocation study. These controls and your dedication to our investment stewardship keep our standards at admirable levels.

Annually, MERS surveys the membership for ways to improve the System. Overall the staff receives high marks for the level of service they provide. Using various benchmarks as comparison to other public systems, MERS receives high scores in administering retirement plans and related products. The staff works diligently to find the appropriate

solutions to meet our members' needs. I am very proud of our staff's competence and dedication to our members.

In closing, I would like to take this opportunity to thank the members of the Board and the staff for their unwavering commitment to provide expertise and professionalism to our members. It has been my pleasure to serve as MERS chairperson. As I leave my position as your chairperson, I am proud to have played a role in the growth of MERS and "Building Success Together."

Sincerely,

Larry Opelt, Outgoing Chairperson

MERS Retirement Board



MERS RETIREMENT BOARD AND CHIEF EXECUTIVE OFFICER



Back row from left to right: Philip LaJoy, Amy Deford, James R. Wiersma, Chris DeRose, John Ogden, Randy Girard

Front row from left to right: Michael Brown, Lori Newberg, Sally Dreves, Michael Gilmore

Officer Members: Michael Brown - Chairperson, Randy Girard, Philip LaJoy

Employee Members: Sally Dreves, Lori Newberg, Amy Deford

Public Members: Michael Gilmore, James R. Wiersma

Retiree Member: John Ogden

MERS OFFICERS



From left to right:

Debra Peake

Carrie Lombardo

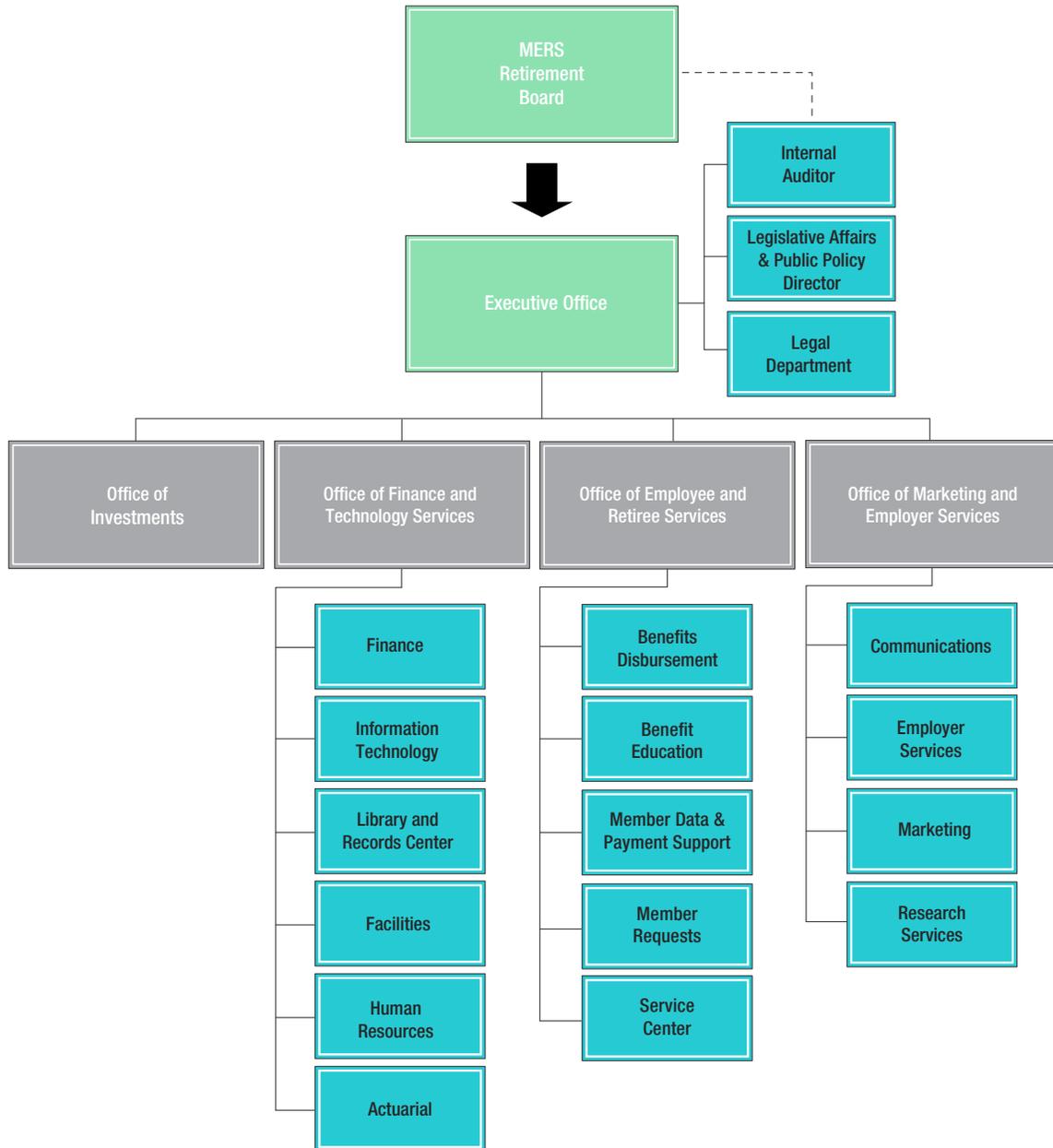
Chris DeRose

Leon Hank

Jeb Burns

MUNICIPAL EMPLOYEES' RETIREMENT SYSTEM OF MICHIGAN

Organizational Structure – 2012



OUTSIDE PROFESSIONAL SERVICES

Professional Consultants

Auditors

Andrews Hooper Pavlik PLC
Mark Jasonowicz, CPA, PLLC

Human Resource Advisors

Gallagher Benefit Services, Inc.

Investment Custodian

State Street Bank and Trust Company

Legal Counsel

Elizabeth Schwartz
Ice Miller, LLP
Miller, Canfield, Paddock & Stone, PLC
Reinhart Boerner Van Deuren S.C.

Legislative Consultants

Karoub Associates
Michigan Legislative Consultants

Medical Advisor

Consulting Physicians

Security Lending Agent

State Street Bank and Trust Company

Systems Implementation and Maintenance

Epicor Software Corporation
HTC Global Services, Inc
Innovative Communications, Inc.
Logicalis
Maner Costerisan
Presidio Networked Solutions
Pro-Tech Cable
Resources Global Professionals
Summit Technologies
Tegrit Financial Group

Third-Party Administrator

Tegrit Administrators, LLC

Investment Managers

Domestic Equity

AMBS Investments
BRC Investment Management
C.S. McKee
Downriver Capital Management
EAM Investors

Hellman Jordan

Irving Magee

Kennedy Capital Management

Mellon Capital

Morgan Dempsey

Punch Investments

Seizert Capital

Wellington Management

International Equity

Acadian Asset Management

BlackRock

Driehaus Global Growth

Hexam

Mountain Pacific Advisors

Fixed Income

BlackRock

C.S. McKee

Credit Suisse

First International Advisors

Janus

Oak Street

Orchard Global

Reams Asset Management

TCW Funds

High Yield

Stone Harbor

Stone Tower

Overlay

Clifton Group

Real Estate

The Townsend Group

Hancock Timber

Urdang Capital Management

Private Equity

AlpInvest Partners

Credit Suisse

Mesirow Financial

Commodities

Cargill Risk Management

Mount Lucas

ACKNOWLEDGEMENTS

The MERS Comprehensive Annual Financial Report (CAFR) for the fiscal year ended December 31, 2012, was prepared by the Office of Finance and Technology Services. Special thanks to the individuals who contributed significant amounts of time and energy to help complete this report. Preparation would not have been possible without their efforts.

Office of Finance and Technology Services

Betsy Waldofsky, Finance Director

Luke Huelskamp, Senior Finance Manager

Courtney Overfield, Accounting Analyst

Danielle Grice, Accounting Analyst

Jen Wyble, Office Administrator

Karen Butka, Administrative Assistant

Robin Towsley, Accounts Payable Coordinator

Additional MERS Staff

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Betsy Schaeffer, Digital Print and Mail Services Supervisor, Office of Marketing & Employer Services

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Mike Schrauben, Investment Officer and Portfolio Manager, Office of Investments

Mike Charette, Senior Investment Officer & Portfolio Manager, Office of Investments

Paul Vangilder, Intern, Office of Investments

Peter Wujkowski, Investment Officer and Portfolio Manager, Office of Investments

Richard Taylor, Print Production Specialist, Office of Marketing & Employer Services

Special thanks are also extended to Andrews Hooper Pavlik PLC, Tegrit Administrators, and Tegrit Financial Group.

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