

INVESTMENT SECTION

Prudent Investment

Our Investments Department, under direction of the Retirement Board, provides strict oversight and due diligence of our investment managers, available investment funds for our participant-directed programs, and ensures our programs meet our standards of security and stability for our members.

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CHIEF INVESTMENT OFFICER REPORT

Dear Members and MERS Retirement Board:

I respectfully submit the investment activity report for the Municipal Employees' Retirement System (MERS) of Michigan's Comprehensive Annual Financial Report for the fiscal year ending December 31, 2012.

As always, our goal as prudent investors is to provide our member municipalities with effective returns at efficient costs, while protecting the pensions and assets of our many members. Our investment returns consistently outperform our benchmarks and market averages, with a prudent, long-term approach designed to provide downside protection and upside market participation.

Economic Overview

The effects of the global economic crisis which began in 2008 are beginning to recede, but the systemic issues which precipitated what is now known as the "Great Recession," continue to play out in the global markets. Slower growth in the developed world should be expected for the medium term. As generational transfer policy issues are addressed heightened market and political volatility will continue. Last year saw several events impact the investing environment: the surprising calm of the European credit crisis, reduced volatility, the U.S. election, continued political dysfunction, and an upward movement of risk assets. Global central banking activity remained accommodative and is likely to remain so through 2014. While markets have stabilized, systemic risks will remain elevated for the medium term. The deleveraging of developed governmental balance sheets is at best a third of the way complete in contrast to the business and consumer sectors. As this process continues, expect significant market movements to present both opportunities and challenges.

The global financial markets posted strong returns throughout the year across all asset

classes. Chinese economic activity began to increase as that country seemed to have avoided a hard landing. The U.S. resolved its electoral issues and is moving slowly toward addressing its structural budgetary concerns. The most recent quarterly GDP numbers show the Eurozone GDP at -0.6% and the U.S. GDP at 1.6% for the 4th quarter with 2.2% U.S. GDP for 2012. U.S. growth slowed in the 4th quarter due largely to cut backs in government spending and tax increases. The housing market saw positive upward momentum with the Case-Shiller index up 8% for the year. Unemployment in the U.S. has continued to remain high at 7.9% and the U6 unemployment at 14.4%, although these numbers are steadily improving as new jobs are being added. In the private sector job growth has increased on average 160,000 jobs per month for 2012. The deleveraging process will negatively impede top line GDP growth for several years to come. A more opportunistic and patient investment approach will be necessary to maximize returns. Industry specific factors and potential inflationary pressures may lead to continued asset price appreciation despite slower economic growth. Lastly, it is worth mentioning that equity markets tend to be leading indicators and current trends should be viewed positively.

MERS Total Market Fund

Regardless of economic and financial turmoil, the defined investment objective of the MERS fund is to grow assets at a rate which, when coupled with contributions, satisfies earned benefits to our members. The Office of Investments strives to achieve a real rate of return of at least 3.50% annually over the rate of inflation and/or exceed the actuarial assumption rate of 8.00% annually. On an absolute return basis, the MERS Office of Investments strives for better performance, but feels confident about MERS performance relative to our benchmarks.

MERS 2012 highlights:

- The MERS Total Market Fund return for 2012 was 11.39% gross of investment fees, which outperformed the actuarially assumed rate of 8.00% by 3.39%.
- The MERS Total Market Fund underperformed its custom policy benchmark gross of investment fees by only 0.04%. This performance is a testament of MERS portfolio asset allocation, active management, and tactical decision-making. The MERS portfolio is specifically designed to provide downside protection during turbulent markets.
- At the broad asset class level, absolute returns gross of investment fees for the year were as follows:

Total Equity	17.88%
Real Estate	13.84%
Fixed Income	6.02%
High Yield	12.69%
Commodities	6.87%
Private Equity	0.50%
Cash	1.12%

In conclusion, I would like to thank the Retirement Board, the fiduciaries of the MERS Plan, for their continued support of the Office of Investments. The clarity of MERS governance structure and the functional checks and balances has allowed the investment program to be successful for our members. This relationship makes for a more efficient decision-making process, benefiting our membership through stronger, risk-adjusted returns.

Respectfully,

Jeb Burns, Chief Investments Officer

REPORT ON INVESTMENT ACTIVITY

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 is individually responsible for under the State of Michigan's Constitution 1963, Article 9, Section 24. MERS is authorized to create subsidiary entities and to provide additional benefits and savings programs to its members at the direction of the Retirement Board. See PA 490 of 2004, 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), PA 314 of 1965, 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, Defined Contribution Plan, Hybrid Plan, 457 Supplemental Retirement Program, Health Care Savings Plan, Retiree Health Funding Vehicle, and Investment Services Program. MERS' Retirement Board (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 Investment Policy Statement (IPS) outlines the investment goals, objectives, and policies of the Fund. The purpose of the IPS is to ensure that the investment activities are carried out within the framework established by MERS policy and administrative documents. The IPS assists the Board, Investment Committee, and staff in effectively monitoring MERS' investment

program and offers a map to assist in making prudent and informed investment decisions. This IPS addresses the following issues:

- The goals of MERS' Investment Program;
- Investment policies;
- Performance objectives and evaluation;
- Major investment programs; and
- Investment processes and procedures.

The IPS is designed to provide sufficient flexibility in the management and oversight process to reflect the dynamic nature of the capital markets. It will serve as a working document and may be modified as needed or as market conditions change. At a minimum, the IPS will be updated annually and approved by the Board.

In accordance with GASB 25, plan investments are presented at fair value. Short-term investments are valued at cost plus accrued interest, which approximates fair value. Securities traded on a national or international exchange are valued at the last reported sales price at current exchange rates. Corporate bonds not traded on a national or international exchange are based upon equivalent values of comparable securities with similar yield and risk. Independent appraisals are the basis for valuing the fair value of real estate. Other investments that do not have established markets are recorded at an estimated fair value. Real estate, private equity, and certain alternative investments typically have a quarter lag in reporting, which is an industry standard. Periodic and independent appraisals of these assets are carried out to ensure an accurate valuation to assist in properly assessing the value of the total fund.

MERS uses a time weighted rate of return calculation methodology based on the market rate of return for the schedule of investment results in the CAFR.

A. DEFINED BENEFIT PLAN

INVESTMENT OBJECTIVES AND ACTIVITY

In conformity with PERSIA, the primary goal of MERS' Investment Program is to grow assets at a rate which, when coupled with employer and employee contributions, satisfies promised benefits to MERS members. This should be done with a high degree of prudence to reduce risk. The following objectives are intended to assist in achieving this goal:

- Maintain the stability of the Plan's funded status
- Maintain adequate liquidity to pay promised benefits
- Adopt a strategic asset allocation plan that reflects current and future liabilities, minimizes volatility and maximizes the long-term total rate of return
- Minimize the costs associated with implementation of the asset allocation through the efficient use of internal and external resources
- Exceed the actuarial investment assumption on a long-term basis, which is currently 8% annually. More specifically, earn a minimum real rate of return of at least 3.5% per year above inflation
- Maintain above median peer rankings for the 3, 5, and 10-year time periods
- Exceed the return of the Fund's Policy Benchmark. The Policy Benchmark currently consists of:

Index	Weighting
Barclays Aggregate Bond Index	30%
S&P 500 Index	20%
Russell 2000 Index	15%
Custom Real Estate Index*	7%
Russell Micro Cap Index	5%
MSCI EAFE Index	5%
MSCI Emerging Markets Index	5%
BofA Merrill Lynch High Yield Master II	5%
DJ UBS Commodities Index	5%
Citigroup 91-day T-bill	3%

PORTFOLIO HIGHLIGHTS

Asset Allocation

The Fund's asset allocation is the single most important determinant of achieving the stated investment goals. The Office of Investments conducts a full asset allocation study every three years to assess portfolio construction and strategy. MERS adopts and implements an asset allocation policy that is predicated on a number of factors, including:

- A projection of actuarial assets, liabilities and benefit payments, and the cost of contributions;
- Historical and expected long-term capital market risk and returns;
- Expected correlations of returns among various asset classes;
- An assessment of future economic conditions, including inflation and interest rate levels;
- Various risk/return scenarios; and
- Liquidity requirements.

Criteria for Inclusion of Asset Classes

The following criteria will be used in assessing an asset class for inclusion in the Fund:

- Sufficient size and liquidity to permit an investment by the Fund;
- Staff and consultant expertise to ensure proper due diligence and cost-effective implementation;
- The incorporation of the asset class contributes to the return enhancement and/or further diversification of the Fund's assets; and
- Ability to readily measure performance and risk against appropriate benchmarks.

Portfolio Weighting Guidelines

- New investment strategies (asset classes or sub-asset classes) will be given:
 - A minimum weighting of 2% of the total portfolio and a maximum weighting of 5% of the total portfolio
 - Allocations may be increased above the 5% threshold after successful integration into the portfolio
 - Strategies may be allocated among several managers to reduce risk
- Each manager will have a maximum allocation of 15% of the Total Fund

The Board adopted the most recent asset allocation study in July 2010. The current plan is:

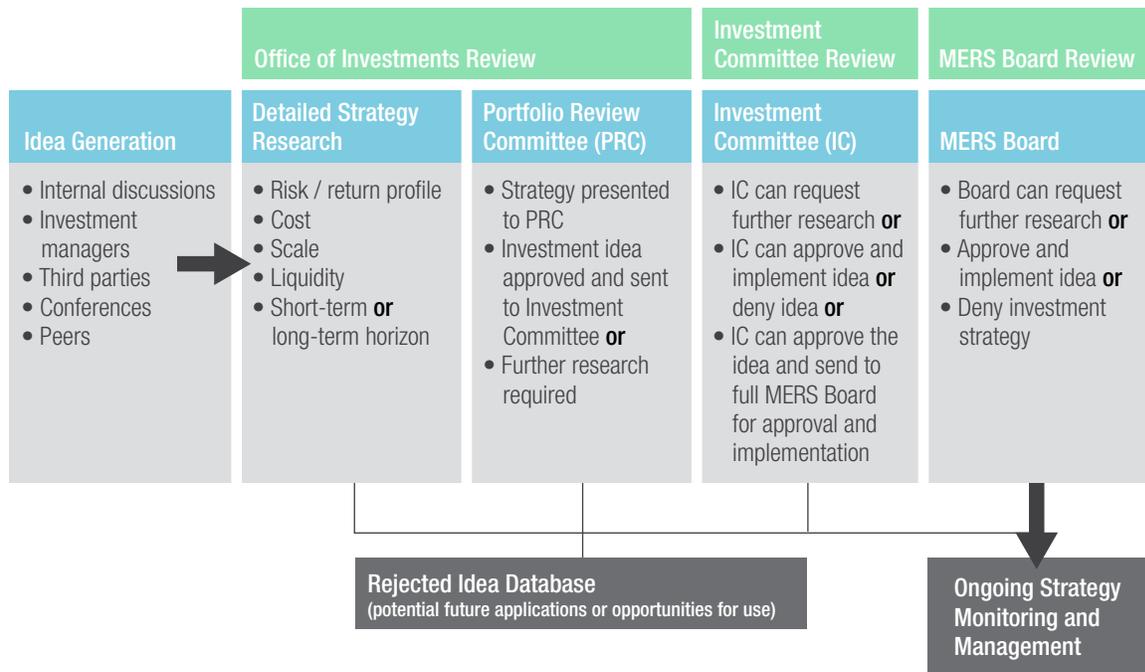
Domestic Equity	34.5%
International Equity	10%
Fixed Income	30%
High Yield	5%
Real Estate	7%
Private Equity	7%
Commodities	5%
Cash	1.5%

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.

Investment Strategy Implementation Process

The team is well positioned to identify appealing investment opportunities through the use of a variety of 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.



INVESTMENT THEMES

As the Total Market Fund continues to evolve, several prevalent themes have emerged as guideposts for the Fund's structure. These broad-based themes will continue to be strongly considered in our decision-making process as we look for investment opportunities to exploit them. We feel successful integration of these themes into the fund will help exceed the stated fund objectives. Naturally, new themes will emerge over time and replace existing themes.

Global Growth

Rapid economic growth in emerging markets such as China and India has created tremendous investment opportunities. Furthermore, population growth will continue to put strain on the world's supply of critical resources. Conversely, the aging of the developed world will create other risks and opportunities. MERS has made numerous investments in an effort to diversify the portfolio and take advantage of these trends and will continue to do so. Currently there is a strong preference toward investing in the U.S. over developed Europe and prudently increasing our emerging market exposure over the medium term.

Active/Passive Mix

The Fund will exhibit a more passive approach in more efficient asset classes. Active management will continue to be utilized in less efficient areas of the market (small/micro cap, emerging markets, credit, etc.) where it has proven to be additive. A more passive approach allows for greater flexibility to invest in unique investment opportunities and reduces management fees without sacrificing returns.

Opportunistic Investing

In an effort to further diversify the portfolio and capture additional alpha, MERS Office of Investments will continue to seek out opportunistic investments. This may result in the portfolio maintaining higher cash balances during certain time periods.

Expanded Mandates

In an effort to give managers a better opportunity to deploy their skill and create alpha, the Fund will move toward expanded mandates for managers. This will result in the blurring of traditional style boxes for managers.

Mean Reversion

Mean reversion is one of the few predictable components of investing — that returns eventually move up or down toward the mean. Thus, our policies and procedures are designed to exploit mean reversion throughout all levels of the portfolio.

Private Investments

Private investments will be looked at through an opportunistic lens and will only be considered to the extent that the reward outweighs the drawbacks (illiquidity and expenses). It is recognized that with the institutionalization of alternative investments, returns will likely be compressed. An effort will be made to make more direct investments and select funds internally to reduce expenses and increase returns. Public investments will be favored all things being equal.

TOTAL MARKET FUND REVIEW

MERS investments generated a gross return of 11.39% for calendar year 2012 using a time-weighted rate of return based on the market rate of return of the portfolio. Performance across all asset classes varied during the year with real estate and international equities generating some of the highest returns, 13.84% and 16.12%, respectively. They were only exceeded by MERS domestic equity, which returned 18.36%.

Asset Class Performance for 2012 (gross of fees) and Contribution to Total Return

Type	2012 Gross Returns	Contribution to Total Return
Domestic Stocks	18.36%	0.53
International Stocks	16.12	-0.52
Fixed Income	6.02	0.78
High Yield	12.69	-0.02
Real Estate	13.84	0.12
Private Equity	0.50	-1.15
Commodities	6.87	0.29

Portfolio Rebalance Policy

MERS adopted a new asset allocation effective July 2010; the Investment Guidelines have been officially amended to reflect this new asset allocation. To ensure that the portfolio remains within the asset allocation parameters established by the Board, the following rebalancing policy has been established. This policy should minimize unintended drift from MERS strategic asset allocation, allow tactical shifts to take advantage of market conditions, and ensure that adequate cash levels are maintained to meet ongoing pension fund expenses. Systematic rebalancing should reduce volatility and increase portfolio returns over the long term.

Daily Review and Optional Rebalance

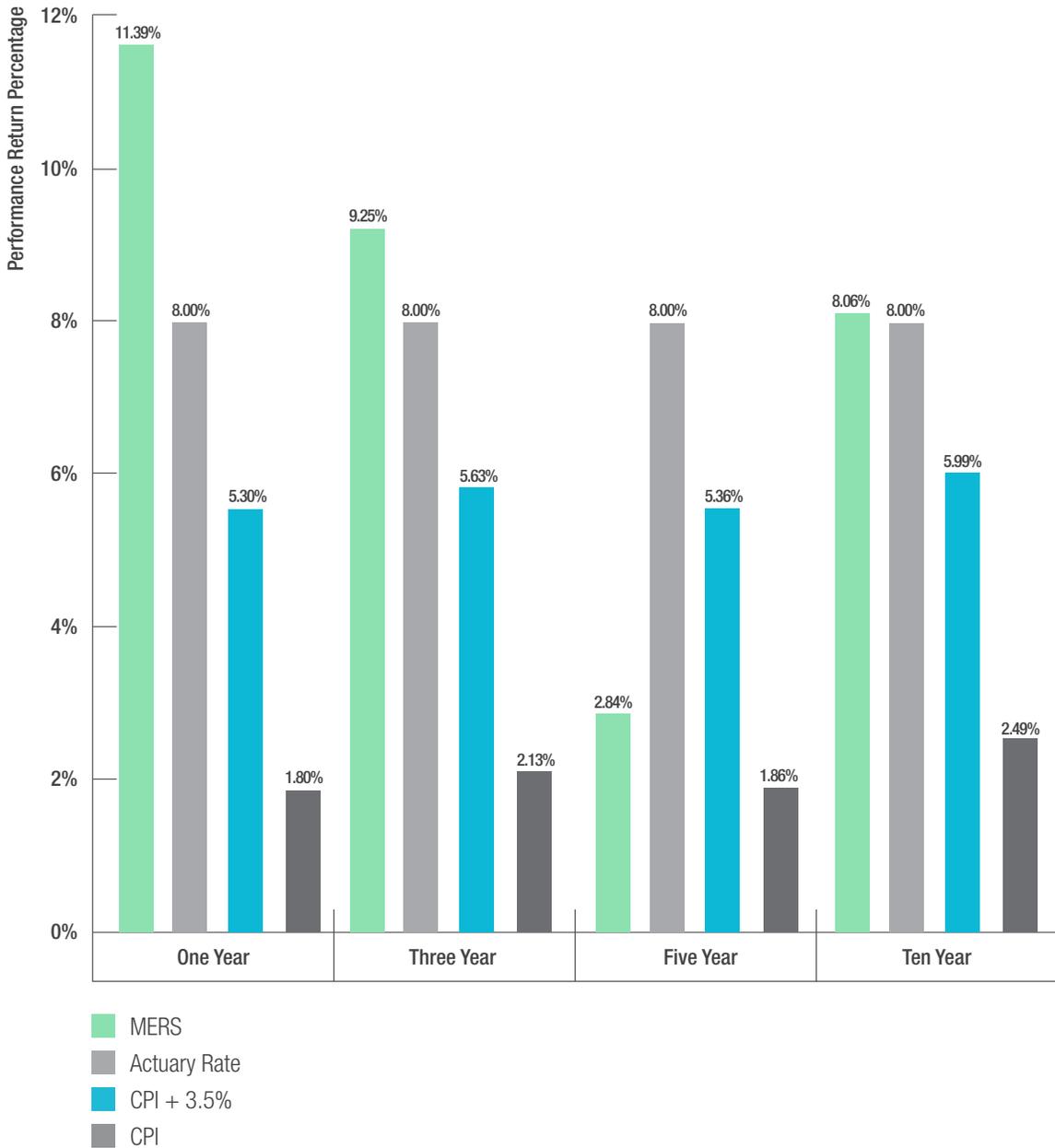
In an effort to minimize tracking error at the Total Fund level, the Office of Investments works with the Clifton Group to monitor allocations and implement a policy overlay using index futures. Asset allocation levels for the following asset classes are monitored daily in relation to the predetermined variation bands, and rebalanced using the appropriate index futures:

Asset Class	Variation Band %	Index Futures
Domestic Equity	± 10%	S&P 500, S&P 400, or Russell 2000 Index
International Equity	± 20	MSCI EAFE Index
Emerging Markets Equity	± 20	MSCI EM Index
Fixed Income	± 10	Barclays Capital Aggregate Bond Index
Commodities	± 20	Goldman Sachs Commodity Index

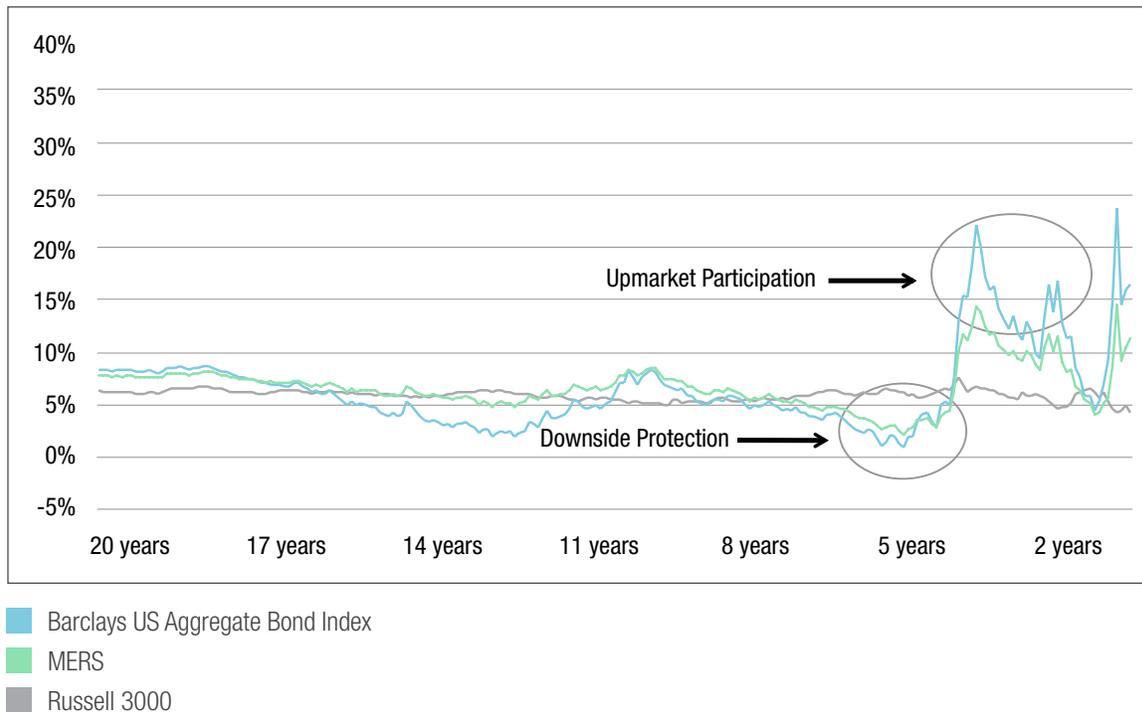
Annual Portfolio Rebalance

The Office of Investments monitors the portfolio's asset allocation on an ongoing basis making strategic and tactical adjustments within the guidelines of the plan. MERS feels that a more robust portfolio-rebalancing regimen can add additional value and reduce the overall risk to the portfolio in certain market environments.

Performance Versus Custom Benchmarks as of December 31, 2012 (gross of fees)

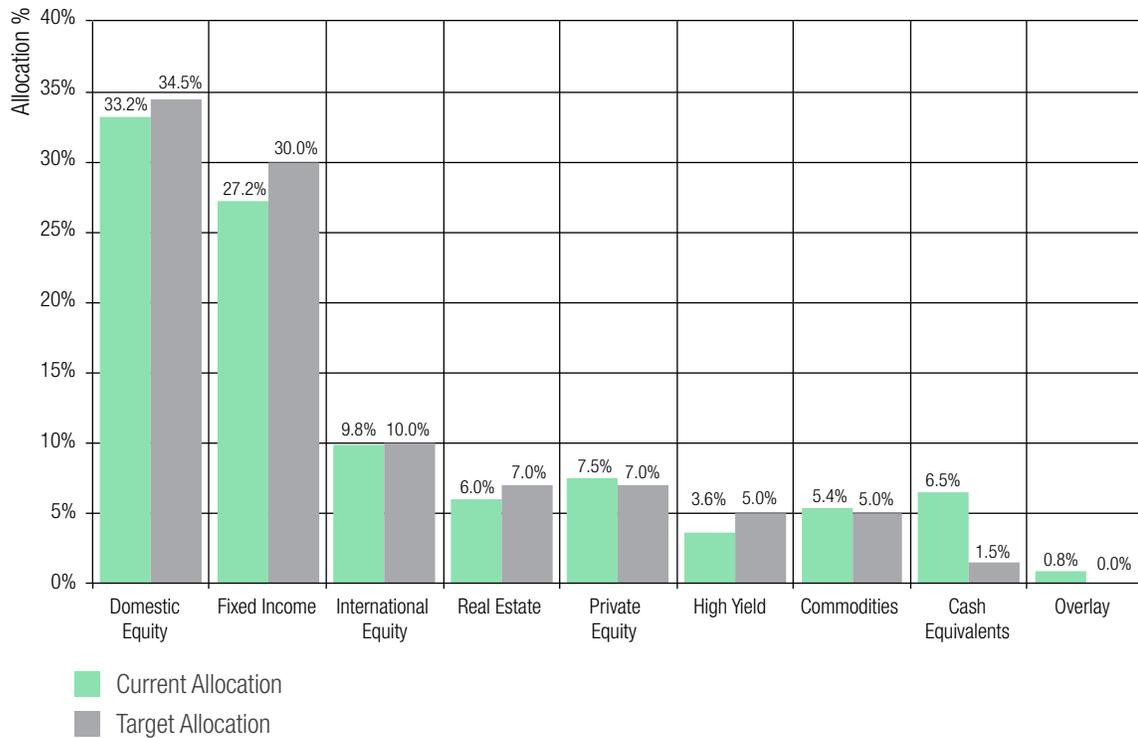


Downside Protection Upside Participation as of December 31, 2012



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.

Current Asset Allocation versus Target Allocation as of December 31, 2012



Statistical Performance (gross of fees)

Portfolio Characteristics	1 Year	3 Year	5 Year	10 Year
Annualized Return (gross of fees)	11.39%	9.25%	2.84%	8.06%
Annualized Standard Deviation	6.96	9.41	12.00	9.57
Sharpe Ratio	1.62	0.97	0.20	0.67
Excess Return	-0.04	0.84	-0.18	0.38
Beta	0.97	0.90	0.86	0.88
Correlation to Policy Benchmark	0.98	0.99	0.99	0.99

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. Notwithstanding these instructions, 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 Total Market Fund's transactions is fulfilled. The SSGM program provides a network of brokers with whom trades can be executed. MERS has the ability

to waive commission recapture participation for investment managers via their investment guidelines as certain strategies are more sensitive to trade execution (i.e. micro cap). The recapture commissions are shared based on a contractually-negotiated split of 90% MERS / 10% broker. Recapture dollars are used to offset the administrative, custodial, accounting, and performance measurement costs incurred by the fund. For 2012 \$108,969 was directed by equity managers to SSGM of which \$98,014 was rebated to MERS.

Securities Lending

MERS participates in the securities lending program at State Street Bank. Income earned from participation in the program is credited to each portfolio within 15 business days of the previous month's end. The goal of the securities lending program is to enhance the overall income of the Plan and to help offset investment management related expenses.

Securities Lending 2012 Rebates and Fees

	Gross Earnings	Rebates	Agent Manager Fees	Net Earnings
First Quarter	\$1,102,658	\$68,773	\$206,694	\$827,191
Second Quarter	1,192,583	139,522	210,537	842,524
Third Quarter	1,416,321	140,543	255,070	1,020,708
Fourth Quarter	1,494,872	159,881	266,865	1,068,126
Totals	\$5,206,434	\$508,719	\$939,166	\$3,758,549

Investment Summary for Defined Benefit Plan, Retiree Health Funding Vehicle, Health Care Savings Program, 457 Supplemental Retirement Program and Investment Services Programs as of December 31, 2012

Type of Investment	Market Value
Fixed Income	
Domestic and International Fixed Income	\$2,307,555,447
Total Fixed Income	2,307,555,447
Equities	
Domestic and International Stock	3,209,834,892
Total Equities	3,209,834,892
Private Equity & Commodities	
Private Equity	558,451,250
Commodities	396,802,951
Total Private Equity & Commodities	955,254,201
Real Estate	
Real Estate	444,998,480
Total Real Estate	444,998,480
Subtotal Investments	6,917,643,020
Cash Equivalents	
Cash Equivalents	479,384,425
Total Cash Equivalents	479,384,425
Total Investments & Cash	\$7,397,027,445

Reconciliation of Investments to Financial Statements

Total Investments from above	\$7,397,027,445
Receivables - Sale of Investments, Interest & Dividends	(913,099,495)
Bonds in default	(860,292)
Small adjustment	(2)
Investments not in MERS State Street' portfolio	291,432,099
Cash at State Street	(33,659,808)
Payables - Purchases of Investments	893,463,701
Investments on Financial Statements	\$7,634,303,648

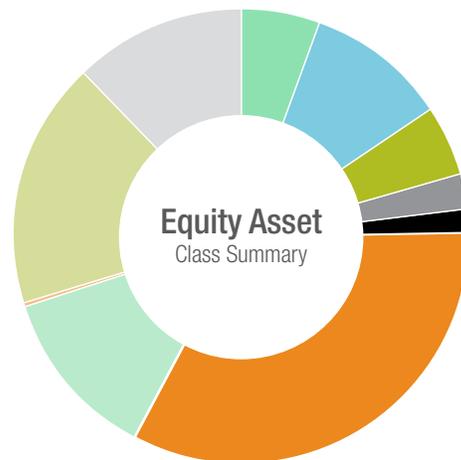
Note: Includes receivables and payables for sales and purchases of securities with settlement dates after December 31, 2012.

EQUITY ASSET CLASS SUMMARY

As of December 31, 2012, the public equity portfolio had a market value of \$3.18 billion, representing 43.0% of the Total Market Fund. Performance for the total equity portfolio was 17.88% gross of fees for the year.

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, 2012, 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. Fiscal year 2012 was relatively calm in terms of activity within the public equity portfolio. Several incremental asset allocation shifts were made throughout the year, but the portfolio remained relatively unchanged from the prior year. The following activities are noted:

- Funded an internal, active micro cap equity portfolio, and hired an emerging micro cap manager
- Microcap Equities were the highest performing segment in the equity space for the year
- Equities and active management were the primary contributors to the funds' success
- During the year, one manager was hired and two managers were terminated.



Small Cap International	5.52%
Global Equities	10.07%
Emerging Markets	4.80%
Frontier Markets	2.49%
All Cap Domestic	1.74%
Large Cap Domestic	32.75%
Mid Cap Domestic	12.26%
Smid Cap Domestic	0.93%
Small Cap Domestic	17.51%
Micro Cap Domestic	11.94%

Market Commentary

During 2012 the “fiscal cliff” threatened significant tax increases and spending cuts. Political accommodation was expected given the extreme effects of a stalemate. Compromise was finally reached in the Senate on December 31, approved in the house on January 2nd, and was signed by President Obama. While negotiations were taking place throughout the year, many feared the ultimate outcome would negatively affect the markets and economy. However, patient investors found 2012 to be a successful year with equity markets earning double-digit returns. The Russell 2000 finished the year up 16.35% while the S&P 500 was up 16.00%. International equities also experienced double-digit returns with small cap and Emerging Markets leading the way. The MSCI ACWI ex U.S. index returned 17.39% for the year and the MSCI EAFE returned 17.32%. Emerging markets were the top performing subasset class, returning 18.63% with frontier markets trailing with only 9.25% in positive returns.

Public Equity Performance as of December 31, 2012 (gross of fees)

Portfolio Characteristics	1 Year	3 Year	5 Year	10 Year
Total Equity	17.88%	9.95%	0.65%	8.68%
Msci World Index Net Daily	15.83	6.93	-1.18	7.51
Excess	2.05	3.02	1.83	1.17
Domestic Equity	18.36	12.27	2.45	8.48
Russell 3000 (Daily)	16.42	11.20	2.04	7.68
Excess	1.94	1.07	0.41	0.80
International Equity	16.12	2.83	-4.27	9.05
Msci Acwi Ex US Gross (Daily)	17.39	4.33	-2.44	10.22
Excess	-1.27	-1.50	-1.83	-1.17

Top 10 Equity Holdings as of December 31, 2012

Asset Description	Market Value	Percentage of Total Market Value
Apple, Incorporated	\$46,653,450	0.63%
Google, Incorporated	15,740,210	0.21
The Toro Company	14,217,784	0.19
Portfolio Recovery Associates, Incorporated	13,995,988	0.19
Qualcomm, Incorporated	13,371,698	0.18
Exxon Mobil Corporation	12,783,435	0.17
Oracle Corporation	12,499,031	0.17
Amazon.com, Incorporated	11,253,834	0.15
JPMorgan Chase and Company	10,674,816	0.14
Equifax, Incorporated	10,417,787	0.14

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

Public Equity – Investment Managers

Investment Manager	Style	Portfolio Market Value
External Investment Manager		
Blackrock	Frontier Markets Enhanced Index	\$79,077,090
Acadian	International Small Cap	175,530,597
Driehaus	All-Cap Global Growth	320,127,784
Mountain Pacific	Emerging Markets	51,549,438
HEXAM	Emerging Markets	100,978,059
Wellington	Large Cap U.S. Growth	215,961,511
Mellon Tangent Added TAA	Large Cap Core/Value	384,608,827
AMBS Investment	Large Cap U.S. Value	30,280,667
Punch Investments	Micro Cap	89,711,145
Morgan Dempsey	Micro Cap	76,746,789
Eudaimonia	Micro Cap	76,022,855
Kennedy Capital	Micro Cap	80,310,604
Downriver Capital	Micro Cap	26,625,684
C.S. McKee	Small Cap U.S. Core	191,276,804
Irving Magee	Small Cap U.S. Value	167,120,758
Kennedy Capital	Small Cap U.S. Value	198,232,443
Hellman Jordan	All-Cap U.S. Core	55,322,543
Seizert Capital	SMID Cap U.S. Value	29,477,609
Wellington	Mid Cap U.S. Core	201,674,276
Internal Investment Manager		
MERS S&P 400	S&P 400 Index	188,172,846
MERS S&P 500	S&P 500 Index	410,307,795
MERS Micro Cap	Active Micro Cap	30,280,896

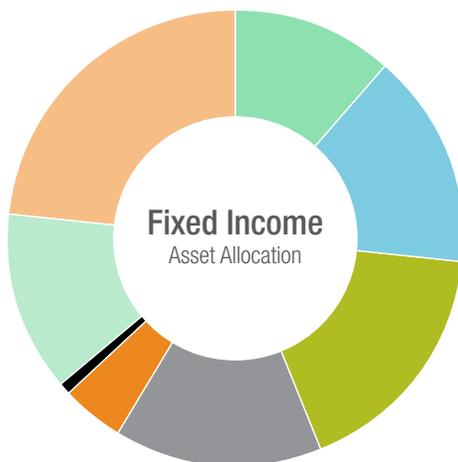
FIXED INCOME & HIGH YIELD ASSET CLASS SUMMARY

As of December 31, 2012, the Total Fixed Income portfolio had a market value of \$2.28 billion representing 30.80% (fixed income of 27.20% and high yield of 3.60%) of the Total Market Fund. Performance for fixed income and high yield was 6.02% and 12.69% gross of fees, respectively.

Fixed Income

Fixed income is the base of the MERS Total Market Fund, providing exposure to high quality securities that provide stable cash flow and liquidity to the overall portfolio. Total fixed income assets, excluding high yield, were \$2.01 billion as of December 31, 2012, and were allocated into eight strategies (see pie chart below). 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 economic growth and stable to falling inflation. During the year one manager was terminated and three were hired.

In mid-2012 the fixed income portfolio changed from a traditional strategy to a core and satellite approach. A core and satellite investment strategy incorporates a passive “core” component and an “active” satellite element. A core investment is the central part of a portfolio. It demands that the investment be steadily reliable throughout the year preserving capital and liquidity. Core is the foundation from which the rest of the portfolio is built. However, the satellite component is where the strategic deployment of active risk occurs, both short term and long term. The main purpose for this approach is to provide the opportunity to earn greater returns than those generated by the core portion of the portfolio.



Infrastructure	11.59%
Active Core	15.27%
Active Global	17.14%
Emerging Market Debt	14.86%
Bank Reg Capital	4.22%
Triple Net Lease	0.85%
Short Duration	12.90%
Core Plus	23.17%

Market Commentary

Fixed income returns were lower than equity markets for 2012, but still outpaced inflation. All sectors of the bond market produced positive returns. Corporate bonds outperformed the broader bond market by a wide margin during this period. They were more attractive than government bonds due to higher yields and the continued improvement in the health of U.S. corporations which led to capital appreciation within the asset class. Corporate profits increased in 2012 and dividend payments increased by more than 15%, reflecting healthy corporate balance sheets amidst a backdrop of slow economic growth.

Treasury yields remained depressed throughout 2012, with the 10-year reaching a record low yield of 1.38% in July 2012. The record low yield environment reflects investors favoring quality assets while fearing macroeconomic risks and slow growth.

Municipal bonds, while sustaining more than their share of bad news in 2012, still delivered respectable returns. While the states' fiscal health is improving, local governments continue to face financial challenges; expenses continue to expand faster than revenues. Regardless of this issue, municipal bonds generated solid gains due to low Treasury rates and favorable supply and demand. Investors continued to take advantage of their attractive yields, driving prices higher.

Fixed Income Performance as of December 31, 2012 (gross of fees)

	1 Year	3 Year	5 Year	10 Year
Fixed Income	6.02%	7.35%	6.45%	6.07%
BC Aggregate (Daily)	4.21	6.19	5.95	5.18
Excess	1.81	1.16	0.50	0.89

Top 10 Fixed Income Holdings as of December 31, 2012

Asset Description	Market Value	Percentage of Total Market Value
GNMA Pool 5.0% 9/15/2039	\$24,140,815	0.33%
Fannie Mae 6.0% 4/18/2036	22,267,051	0.30
United States Treasury 1.25% 7/15/2020	18,338,899	0.25
United States Treasury 0.5% 4/15/2015	16,864,799	0.23
Fannie Mae 5.5% 4/1/2036	15,880,572	0.21
Federal Farm Credit Bank 1.0% 1/17/2017	12,347,053	0.17
United States Treasury 0.625% 4/15/2013	11,508,534	0.16
United States Treasury 1.75% 4/15/2014	11,183,480	0.15
Canada Housing Trust 3.15% 6/15/2014	11,155,228	0.15
Fannie Mae 6.0% 3/1/2037	11,082,055	0.15

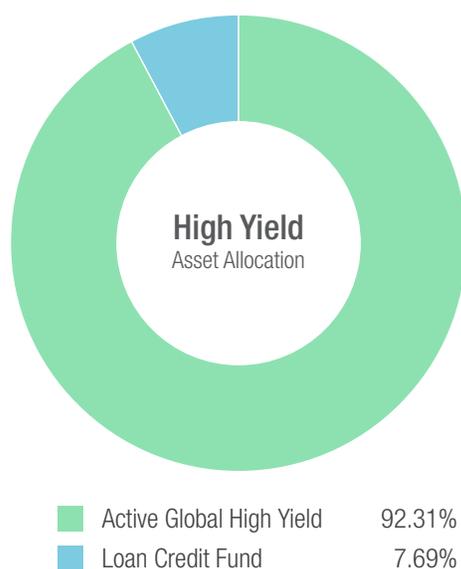
Note: A complete list of portfolio holdings is available upon request.

Fixed Income – Investment Managers

Investment Manager	Style	Portfolio Market Value
External Investment Manager		
Credit Suisse	Infrastructure	\$233,474,039
C.S. McKee	Core Fixed Income	307,546,646
First International Advisors	Global Bonds	345,100,682
Janus Capital Management	Core Plus	466,484,642
Janus Capital Management	Short Duration	259,720,625
Oak Street Real Estate Capital	Triple Net Lease	17,171,832
Orchard Global Capital	Bank Regulatory Capital	84,908,437
TCW	Emerging Market Debt	299,294,023

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, 2012, were \$264,322,552 and were allocated into two strategies (see pie chart below). The strategy employs opportunistic mandates that seek to capitalize on market inefficiencies. A blended approach is expected to deliver returns in excess of U.S. high yield benchmarks with less volatility. One manager was terminated from the high yield portfolio during 2012.



Market Commentary

High yield bonds produced strong positive performance in 2012, as the ultra-low rates on safer assets caused investors to gravitate to the more attractive income available in this area. The Bank of America Merrill Lynch U.S. High Yield Master II Constrained Index posted a positive total return of 15.58% as of December 31, 2012. High yield was also pushed by the improvement in the financial health of the underlying issuers, as seen in the rising earnings and strengthening balance sheets of U.S. corporations. Many wonder if these trends will continue into 2013

High Yield Performance as of December 31, 2012 (gross of fees)

	1 Year	3 Year	5 Year	10 Year
High Yield	12.69%	12.04%	5.23%	8.66%
BofAml High Yield Master II (Daily)	15.58	11.60	10.01	10.39
Excess	-2.89	0.44	-4.78	-1.73

High Yield – Investment Managers

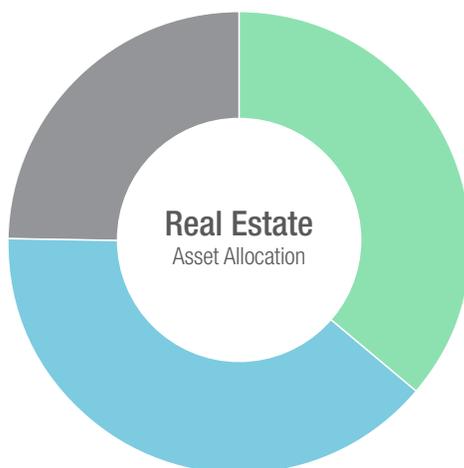
Investment Manager	Style	Portfolio Market Value
External Investment Manager		
Stone Harbor	High Yield/ EMD/ TIPS	\$243,985,238
Stone Tower	Loan Credit Fund	20,337,314

ALTERNATIVE ASSET CLASS SUMMARY

As of December 31, 2012, the alternatives portfolio had a market value of \$1.40 billion representing 18.9% (real estate of 6.00%, commodities of 5.40%, and private equity of 7.50%) of the Total Market Fund. Performance for real estate, commodities, and private equity was 13.84%, 6.87%, and 0.50%, 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, inflation protection, consistent income, and uncorrelated returns to the Total Market Fund.



Urdang	\$161,580,420
Townsend	\$173,756,398
Hancock Timber	\$109,661,662

Market Commentary

Private Property

The underlying momentum for economic growth has been moving up in recent months. The high demand for yield and the current cash flows in this asset class have contributed greatly

to the upward price movement. Commercial property markets improved in late 2012 despite uncertainty about the fiscal cliff. Construction activity remained low relative to demand across much of the commercial real estate market. However, the typical lag between the index movement and resulting construction spending indicated that construction activity will increase in the following 9 to 12 months, primarily driven by a large multifamily development pipeline. Vacancies across property types were lower through the fourth quarter of 2012. Private equity U.S. real estate transaction volume totaled approximately \$275 billion in 2012. The average capitalization rate, as reported by NCREIF, was 6.84% for the year.

REITs

REITs, as measured by the FTSE NAREIT Index, continued to perform well for the year returning 18.06%. There has been an increased demand for yield in REITs which, along with present cash flows, has added significantly to the mounting price movement.

Global Real Estate delivered healthy total returns in 2012 and this trend has carried through the New Year. For 2013, improving global economic growth will facilitate further increases in real estate cash flows through higher property occupancies and in cases where occupancy has reached/will reach equilibrium, higher rents. The best performing property sectors during the last quarter were Self Storage, Health Care, Industrial, and Regional Malls. Conversely, Mixed Office and Industrial, Manufactured Home Sites, Shopping Centers and Office lagged in comparison.

Timber

MERS has invested in Timber since 1995, and has looked at this portion of the portfolio to provide diversification, current income, and capital preservation through its inflation-sensitive pricing characteristics. Due to the subprime mortgage crisis and related collapse of the U.S. housing market, demand for timber has suffered in recent years. As a result, returns from the asset class have been muted since 2008, with the five-year return coming in below 1% annually. Since inception, however, MERS' investments in timber have performed more as expected, generating an annualized return of 6.54% net of fees.

Market Commentary

The outlook for North America timber markets will be determined by the timing and strength of the recovery of U.S. residential construction, which undeniably began in the second half of 2012. A unique characteristic of timberland, however, is that it functions as both a factory and a warehouse. This gives investors in timber the flexibility of harvesting trees when timber prices are up, and delaying harvests when prices are down. So while we would expect that the steep and swift recovery in US housing markets would fuel a rebound in U.S. lumber and timber markets, the deferred harvest over the previous five years will moderate the recovery in timber prices.

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 and cattle exposure through a new manager hire, Australian Pastoral Fund. Only one manager was terminated from the commodities allocation. The commodities portfolio was further diversified with recent direct Investments in pastoral land in Australia. This investment will further diversify the portfolio, increase the correlation benefit, and capitalize on global population growth.

Market Commentary

Commodities income at the 10 largest banks slumped 24% last year to \$6 billion. The Standard & Poor's GSCI Spot Index of raw materials climbed less than 0.3% in 2012, the worst performance in four years. Slower growth in China and below trend growth in the developed world is depressing prices. Things do not appear to be turning around for commodities in 2013. Low volatility and reduced client activity have caused a drop in commodity revenues in 2012. Increasing concerns about regulation and capital sensitivity also led banks to re-examine commodity strategies. The Dodd-Frank Act, the creation of which is being closely watched in anticipation of its completion, has already banned proprietary trading and designed rules to increase transparency in derivatives markets are among regulations. These changes and the fear of other possible restrictions have affected the processes and nature of this asset class.

Private Equity

MERS private equity target allocation represents 7% of the Total Market Fund and its role within the portfolio is to provide diversification from public equity investments and enhanced returns, as compensation for the higher level of risk undertaken in this asset class. Investments in private equity include U.S. and international, venture capital, buyout, and special situation funds. Private Equity returns for the calendar year 2012 underperformed its benchmark, the Russell 2000 public equity index, primarily due to the different ways that results are reported. The Russell Index is marked to market daily, as the share prices of the publicly traded equities that comprise the Index are reported daily. Private Equity investments are valued quarterly by underlying investment managers, which use their opinions of current market conditions to arrive at internal valuations as of a given reporting date. The process of looking back at quarterly results and determining value in a look-back fashion creates a reporting lag relative to public equities, which can range from 6-12 months depending on the reporting requirements of underlying investments. As a result, some of the rally in the public equity markets that occurred in the second half of 2012 has yet to be reflected in private equity valuations, which accounts for some of the relative underperformance of the asset class.

It should also be noted that Private Equity is a long-term asset class and its performance is more fairly evaluated on a longer time horizon. The asset class has performed much better relative to its benchmark over longer time periods, exceeding the Russell 2000 index over the five and seven-year time periods. MERS staff expects that the portfolio of private markets investments will continue to provide long-term benefits for the Total Market Fund.

Market Commentary

Deal volume in the private equity space showed modest improvement during 2012. According to S&P Capital IQ, North American target deal volume increased 4.1% to 17,423 transactions in 2012 from 16,730 in 2011. Strategic M&A improved 4.0% to 16,213 deals in 2012 from 15,586 in 2011, while leveraged buyout volume rose 5.8% to 1,210 from 1,144 transactions. Separately, non-buyout private equity investments fell 16.4% to 2,916 from 3,487 during the same period.

The dollar value of North American buyout transactions shrank 4.7% to \$1.02 trillion in

2012 from \$1.07 trillion in 2011. The bulk of the deal value is a result of strategic merger and acquisition transactions, which accounted for \$910.6 billion in dollar value in 2012. This is a decline 7.3% from the 2011 level of \$982.8 billion. The value of leveraged buyouts grew 23.4% to \$112.1 billion from \$90.8 billion, which is reflective of the re-emergence of the mega-deal in 2012, which also grew the average deal size 16.7% to \$92.6 million from \$79.4 million in 2011.

Alternative Performance as of December, 31, 2012 (gross of fees)

	1 Year	3 Year	5 Year	10 Year
MERS Real Estate	13.83%	8.05%	-0.70%	7.21%
MERS Custom Real Estate Benchmark	13.29	8.64	3.18	9.54
Excess Return	0.54	-0.59	-3.88	-2.33
MERS Commodities	6.87	6.71	-3.13	-
MERS Custom Commodities Index	-1.06	2.15	-8.33	-
Excess Return	7.93	4.56	5.20	-
MERS Private Equity	0.50	10.63	4.44	6.17
Russell 2000	16.35	12.25	3.56	9.72
Excess Return	-15.85	-1.62	0.88	-3.55

Alternatives – External Investment Managers

Investment Manager	Style	Portfolio Market Value
Real Estate		
Townsend	Private Real Estate	\$173,756,398
Urdang	Global REIT	161,580,420
Hancock	Timber	109,661,662
Commodities		
Cargill	Enhanced Index	333,538,950
Private Equity		
Credit Suisse	Fund of Funds & Co Investments	507,201,866
Mesirow Capital Partners	Fund of Funds & Co Investments	26,054,362
AlpInvest	Fund of Funds & Co Investments	25,195,022

INVESTMENT MANAGEMENT FEES

Since management fees directly affect the returns of a manager, a best effort is made to achieve the best fee agreement possible. MERS leverages the scale of investments to negotiate deals that are at the lower end of industry standards and more than competitive with peers. While it is understood that superior managers often have higher fee structures, performance expectations and cost are carefully balanced. Fees are the only factor that one can be certain of ex ante; thus it is critical to minimize them to the extent possible. All else being equal, managers with lower fees will be favored.

Schedule of Investment Fees – as of December 31, 2012

Investment Managers	Average Assets Under Management	Annual Fee	Average Basis Points
Acadian Asset Management	\$163,485,670	\$785,208	48.03
AMBS Investment	29,471,075	58,908	19.99
BlackRock- Core Active Bond	218,816,983	114,037	5.21
BlackRock- Frontier Markets	75,219,510	547,613	72.80
BRC Investment Management	67,329,273	84,211	12.51
Credit Suisse Customized Infrastructure	241,473,129	1,916,856	79.38
Credit Suisse Private Equity Fund	555,402,586	371,155	6.68
C.S. McKee- Small Cap Core	187,410,984	824,622	44.00
C.S. McKee- Fixed Income	294,941,119	445,234	15.10
Downriver Capital Management	26,069,526	78,543	30.13
Driehaus Global Growth	315,575,346	949,748	30.10
EAM	75,945,968	761,392	100.25
First International Advisors	334,381,437	769,190	23.00
Hellman Jordan	35,211,025	156,032	44.31
Hexam	97,006,473	679,097	70.01
Irving Magee	161,451,717	909,888	56.36
Janus- Core Plus	456,880,512	566,348	12.40
Janus- Short Duration	280,377,661	202,675	7.23
Kennedy Capital Management- Micro Cap	76,418,069	691,629	90.51
Kennedy Capital Management- Small Cap Value	191,196,520	797,442	41.71
Mellon Tangent Added TAA	392,806,283	667,517	16.99
Morgan Dempsey	73,729,038	516,684	70.08
Punch Investments	83,219,566	741,659	89.12
Reams Asset Management	134,509,839	154,243	11.47
Seizert Capital	27,587,330	110,349	40.00
Stone Harbor	233,019,214	578,439	24.82
Urdang Investment Management	150,600,712	775,805	51.51
Wellington Management	210,089,084	535,182	25.47
Wellington Management- Mid Cap	195,503,975	1,072,694	54.87
The Townsend Group	160,457,344	247,741	15.44
Total Investment Manager Fees	\$5,545,586,968	\$17,110,141	30.85
Investment Custodian			
State Street Bank and Trust		1,055,791	
Investment Performance Measurement Consultant			
State Street Bank and Trust		102,000	
Securities Lending Agent			
State Street Bank and Trust		939,166	
Total Investment Fees		\$19,207,098	

Schedule of Investment Commissions as of December 31, 2012

Brokerage Firm	Shares Traded	Total Dollars	Commission/Share
Instinet	22,827,339	\$304,524	0.0133
Cantor Fitzgerald & Company	11,610,960	262,998	0.0227
State Street Bank and Trust	20,067,767	204,803	0.0102
Knight Equity Markets, LP	6,398,731	114,939	0.0180
Knight Direct LLC	7,152,110	93,559	0.0131
Merrill Lynch, Pierce, Fenner, and Smith Inc	4,503,149	90,871	0.0202
Bloomberg Tradebook, LLC	7,234,506	89,743	0.0124
JonesTrading Institutional Services, LLC	3,932,811	86,375	0.0220
Weeden & Company	2,922,962	77,084	0.0264
Wm Smith & Company	2,058,797	65,683	0.0319
Capital Institutional Services, Incorporated	2,037,451	65,508	0.0322
State Street Global Markets, LLC	1,504,281	63,666	0.0423
Craig-Hallum Capital Group LLC	2,552,489	58,010	0.0227
Robert W. Baird and Company	1,422,340	48,535	0.0341
Credit Suisse Securities	12,269,957	48,519	0.0040
Raymond James and Associates Incorporated	1,497,128	44,831	0.0299
Morgan Stanley and Company Incorporated	6,284,403	43,680	0.0070
Cowen and Company, LLC	1,364,546	42,058	0.0308
J.P. Morgan Clearing Corporation	1,232,279	35,972	0.0292
Needham & Company	1,291,825	34,529	0.0267
BNY Brokerage	2,445,554	34,205	0.0140
Goldman Sachs & Company	3,779,314	34,083	0.0090
Stifel, Nicolaus, & Company, Incorporated	1,508,693	33,093	0.0219
RBC Capital Markets	1,994,984	32,847	0.0165
Gilford Securities	980,930	32,603	0.0332
Subtotal (25 Largest)	130,875,306	2,042,718	0.0156
Remaining Total	92,426,194	955,221	0.0103
Total Commissions	223,301,500	\$2,997,939	0.0134

B. MERS INVESTMENT MENU SUMMARY FOR THE DEFINED CONTRIBUTION PLAN, HYBRID (PART II) PLAN, HEALTH CARE SAVINGS PROGRAM, AND 457 PROGRAM

The MERS Retirement Board, together with the Office of Investments, selects the menu of investment options for the MERS Defined Contribution Plan, Hybrid Plan (Part II), Health Care Savings Program, and 457 Supplemental Retirement Program. In addition, the Board establishes and maintains investment guidelines, approves any material changes, and directs staff to help participants with investment education.

The MERS Investment Menu is simplified into four categories or “sleeves” which help streamline the participant’s selection process. For performance and fee information of individual funds, please review the *MERS Investment Menu Fund and Fee Summary*, which is updated on a quarterly basis and available on the MERS website at www.mersofmich.com/investments. A full description of each investment option can also be found on the MERS website.

Retirement Strategies

Retirement Strategies are also known as Target Date Funds. Each fund is a complete, diversified investment program that changes its asset mix as the participant moves toward and through retirement. Retirement Strategies are the default investment selection for the Defined Contribution Plan, Hybrid Part II, and the 457 Program.

Diversified Portfolios

Diversified Portfolios are professionally managed by MERS, and allow access to certain MERS investments. Each fund is a fully diversified portfolio with a target allocation that is rebalanced quarterly. The Diversified Portfolios include the Established Market Fund, which is the default selection for the MERS Health Care Savings Program.

Expanded Funds

Expanded Funds give experienced investors a variety of available funds from which to choose. Used in conjunction with any of the other sleeves of the MERS Investment Menu or by themselves, these funds are designed to further diversify a participant’s investment portfolio.

Self-Directed Brokerage Window

The Self-Directed Brokerage Window offers access to a broader selection of funds. Several requirements are needed to be eligible as well as a minimum account balance. The Brokerage Window is not available for the MERS Health Care Savings Program.

C. MERS RETIREE HEALTH FUNDING VEHICLE

The MERS Retirement Board and Office of Investments actively choose and monitor the fund lineup available to employers enrolled in the Retiree Health Funding Vehicle. MERS values a disciplined 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 funds available in the Retiree Health Funding Vehicle are:

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

D. MERS INVESTMENT SERVICES PROGRAM

The Investment Services Program provides municipalities with 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.

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