

SERS PLAN 3 REPORT August 2005

Visit ICMA-RC on the Internet at: <http://www.icmarc.org/plan3/>

Protecting DRS Members' Investments

Maximizing and safeguarding your retirement investments is the Department of Retirement Systems' (DRS) highest priority. For that reason, we're working with the Washington State Investment Board (WSIB) to develop policies and procedures that will prohibit harmful trading practices such as excessive trading.

Excessive trading involves transferring significant amounts of money and/or making frequent trades between investment options typically in an attempt to lock in short-term gains or avoid short-term losses. This practice requires more cash on hand to honor the frequent trades and transfers. Because the excess cash is used to cover potential transfers instead of being invested, long-term returns can be lowered for other members. Excessive trading may also increase fund management costs.

Again, we make it our highest priority to ensure you get the most from your retirement investments. Should we identify an individual engaging in the detrimental practice of excessive trading, we will take action to stop it. Corrective measures may include restricting transfer volume and limiting or closing access to investment options.

Details on excessive trading restrictions will be provided in the near future, through the *SERS Plan 3 Report* and our Web site at www.drs.wa.gov.

New Contract with ICMA-RC

Effective July 1, ICMA Retirement Corporation's (ICMA-RC) record-keeping fee for Self-Directed Plan 3 funds will decrease from 0.1500 percent to 0.1100 percent. In December 2004 DRS entered into a new contract with ICMA-RC to provide record-keeping services for all Plan 3 accounts. The

SERS PLAN 3 WSIB TOTAL ALLOCATION PORTFOLIO (TAP)

AS OF 6/30/2005

	AVERAGE ANNUAL RETURNS			
	2nd Qtr 2005	1-Year	3-Year	5-Year
TOTAL ALLOCATION PORTFOLIO	3.21%	13.05%	10.77%	3.75%

The Washington State Investment Board (WSIB) periodically reviews and adjusts the TAP Fund's asset allocation. Over the last five years, the TAP Fund has shifted to a more aggressive asset mix. These returns reflect the actual asset mixes during the time periods shown.

SERS PLAN 3 SELF-DIRECTED FUNDS

AS OF 6/30/2005

	2nd Qtr 2005	1-Year	3-Year	5-Year
MONEY MARKET FUND	0.67%	2.05%	1.48%	N/A
WASHINGTON STATE BOND FUND	2.48%	5.25%	5.82%	N/A
SOCIALLY RESPONSIBLE BALANCED FUND	0.43%	4.45%	N/A	N/A
U.S. LARGE STOCK INDEX FUND	1.32%	6.13%	8.11%	N/A
U.S. STOCK MARKET INDEX FUND	2.21%	7.89%	9.31%	N/A
U.S. SMALL STOCK INDEX FUND	4.28%	9.31%	12.57%	N/A
INTERNATIONAL STOCK INDEX FUND	-0.91%	13.65%	10.19%	N/A
SHORT-HORIZON FUND	1.72%	5.92%	6.21%	N/A
MID-HORIZON FUND	1.90%	7.86%	8.53%	N/A
LONG-HORIZON FUND	1.72%	8.99%	9.56%	N/A

The SERS Plan 3 Self-Directed Funds were available for investment on September 1, 2000 and have no performance history prior to this date. Actual inception dates (start of fund activity) are: U.S. Stock Market Index, U.S. Large Stock Index, Mid-Horizon and Money Market on October 6, 2000; International Stock Index, U.S. Small Stock Index, Washington State Bond, Short-Horizon and Long-Horizon on October 10, 2000 and Socially Responsible Balanced Fund on April 1, 2004.

All returns are net of fees. Self-Directed funds are valued daily; your account balance and rate of return will vary accordingly. Past performance is no guarantee of future results. For more information about the funds, please see the *Plan 3 Investment Guide* or the Web site at www.icmarc.org/sers/investing.

Returns cover the period ending June 30, 2005.

N/A - Not Applicable

contract completed a competitive procurement process initiated by DRS and reflects a continuing effort by both organizations to provide the best service at the lowest possible cost.

Change in Plan 3 Management Fee

Effective July 1, the Washington State Investment Board's (WSIB) Plan 3 management fee will increase slightly, from 0.0129 percent to 0.0132 percent - or approximately 3 cents for every \$10,000 invested. The fee adjustment will fund the professional staff needed to enhance fund performance and oversight in today's challenging investment climate.

For more information on Plan 3 fees, consult the *Plan 3 Investment Guide*. The *Guide* is available on the ICMA-RC Web site at www.icmarc.org/plan3, or you may obtain a copy by contacting ICMA-RC at 1-888-711-8773.

Posting Contributions to Your Defined Contribution Account

As soon as your Plan 3 contributions are deducted from your paycheck, the investment process is quickly set in motion. We thought it would be helpful to give you a summary of how it works:

1. Contributions are deducted from your paycheck.

2. Your employer sends your contributions to DRS. State law mandates this must occur by the 15th of the month following the month they were deducted from your paycheck.
3. DRS deposits your contributions with the Office of the State Treasurer (OST) the same business day they are received.
4. Your contributions are then forwarded to the investment program you indicated with your employer, either the Washington State Investment Board's (WSIB) Total Allocation Portfolio (TAP) or the Self-Directed Investment Program. Depending on which of the two investment programs your contributions are directed to, the process continues to either No. 5a or No. 5b below.
- 5a. If you invest in the WSIB TAP, money received during the month is invested in the WSIB Short-Term Investment Fund (STIF) and begins to earn the fund's yield on the next business day. Because the WSIB TAP is a monthly valued fund, your contributions remain invested in the WSIB STIF until the first business day of the next month, when they are then invested in the WSIB TAP.
- 5b. If you invest in the Self-Directed Investment Program, OST sends your contributions to a custodial bank account where the funds are invested in a STIF. If the funds are deposited by 1:00 pm Pacific Time, they are invested the same business day. If they are deposited after 1:00 pm Pacific Time, they are invested the next business day.
6. In both investment programs your funds remain in a STIF and draw earnings in that fund until the contribution detail (i.e., information that indicates how you wish to have your contributions invested) is reconciled with your funds. Your money is then invested according to your investment program and allocation.

If you would like more information about this process, please refer to the *Plan 3 Investment Guide* that is

available on the Plan 3 Web site at www.icmarc.org/plan3 or contact ICMA-RC at 1-888-711-8773.

Market Commentary as of May 31, 2005

As May drew to a close, the pace of U.S. economic growth was at the forefront of investors' minds. The U.S. Gross Domestic Product grew at 3.1 percent for the first quarter of 2005, below estimates and behind the 3.8 percent growth of the fourth quarter of 2004. Growth in consumer spending now accounts for two-thirds of U.S. economic activity; although it remained strong, it fell somewhat this quarter, increasing concerns that higher energy prices were taking their toll on consumer spending. Investors still had reason for optimism, however, based on relatively strong first quarter corporate earnings. Concern about inflation eased as the Federal Reserve continued its measured rate hikes, increasing the overnight rate a quarter point for the eighth consecutive session.

Bonds

After a poor start early in 2005, the bond market gained some traction at the close of May. Investors showed a clear preference for higher quality bonds, even as some of the largest issuers (including GM and Ford) were facing significant downgrades in their credit quality. This flight to quality pushed Treasuries into the top-performing category, a change of pace given the success of lower quality bonds over the past few years. Overall, bonds rose 1.9 percent during the three-month period as measured by the Lehman Brothers Aggregate Index, while the more volatile Lehman Brothers High Yield Index finished in the red with a 2.2 percent loss. Longer-term bonds had some impressive capital gains and significantly outpaced shorter-term bonds.

Stocks

Stocks ended the quarter extremely close to where they began, with some volatility along the way. The weakness experienced in March and

April turned into May's strength as all major stock indexes posted solid gains to close the three-month period. Small cap stocks, which were beaten down early in the year, came roaring back in May but still finished down for the period. After trailing small cap stocks for five consecutive years, large cap stocks have finally showed signs of taking the leading position as the S&P 500 Index finished the quarter with a loss of 0.6 percent compared to the 2.4 percent loss experienced by the Russell 2000 Index. Style returns were mixed as growth outpaced value in larger cap stocks while the opposite was true in the smaller capitalization range. From a sector perspective, Energy and Basic Materials shares slid after leading the pack for much of 2004 and early 2005, giving way to long-ignored sectors such as Healthcare and Technology.

International stocks experienced broad-based gains in local currency with the notable exception of Japan, which continued to dampen the Asian Pacific region's otherwise strong performance. Despite these impressive gains, international stocks as a group failed to outperform the U.S. market as the MSCI ACWI ex-US lost 1.9 percent for the quarter when converted to U.S. dollars. Currency has played an integral role in international stocks' outperformance of domestic stocks over the past few years. This trend reversed during this period as the U.S. dollar began to show signs of strength. Nordic countries such as Sweden and Finland, in addition to Hong Kong and Singapore, were among the few to outpace the U.S. Emerging Markets which continued to produce positive results as the MSCI Emerging Markets Index gained 0.8 percent. Latin America, Egypt and India were particular areas of strength.

*By Arnerich Massena & Associates
Due to printing requirements, this article includes market activity as of May 2005.*