

Operations Summary

**California Public Employees' Retirement System
Year Ended June 30, 2003**



CalPERS Profile

The California Public Employees' Retirement System (CalPERS) is the nation's largest public pension fund and the second largest in the world, with assets at June 30, 2003 of approximately \$144 billion.

Headquartered in Sacramento, CalPERS provides retirement and health benefit services to more than 1.4 million people and more than 2,500 public employers. The System also operates eight regional offices located in San Francisco, Glendale, Orange County, Fresno, Sacramento, San Bernardino, San Diego, and Mountain View.

CalPERS is led by a 13-member Board of Administration, consisting of member-elected, appointed, and ex officio members.

Our membership consists of 1,014,360 active and inactive members from the State, school districts, and local public agencies, and 396,151 retirees, beneficiaries, and survivors. Established by legislation in 1931, the System became operational in 1932 for State employees only. In 1939, public agencies were allowed to contract with CalPERS to provide retirement benefits for their employees. We began administering health benefits to State employees in 1962 under the Public Employees' Medical and Hospital Care Act. Local public agencies joined in our Health Program on a contract basis five years later.

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Year Ended June 30, 2003

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President's Message

Dear Friends:

I am honored to serve as the new President of the CalPERS Board of Administration and am equally honored to introduce this report on our accomplishments this past fiscal year.

Fiscal year 2002-03 was a time of unprecedented change that resulted in significant challenges for the System. Fiscal security and economic concerns loomed large in California and the nation. The State's budget crisis continued, and our employer rate increases did not abate. Yet, we also found this period to be an exciting time of opportunity, the kind of climate in which CalPERS historically has risen to the challenge.

This past year we added a number of new leaders to our CalPERS team. We welcomed three new Board members—State Controller Steve Westly, Priya Sara Mathur, and George Diehr. We hired a new Chief Executive Officer, Fred Buenrostro to head our operations. We are confident they will continue the legacy of excellence demonstrated by those officials who preceded them.

While the challenges of the past year gave us cause for reflection and review, despite these conditions we met crises head on and continued to provide quality services to our various constituencies. In spite of the difficult issues that faced us, we made measurable advances.



Sean Harrigan, President

The CalPERS Operations Summary and Comprehensive Annual Financial Report for June 30, 2003 is a reflection of our hard work and achievements. The pages demonstrate our confidence in our ability to provide secure, stable pensions and health coverage for our members and their families while keeping in mind the needs of our employers.

One of our most significant accomplishments of the year is the achievement of positive investment returns. CalPERS posted a positive 3.7 percent investment return, ending a two-year run of negative performance. Our long-term investment performance remains strong. Annually compounded over the past 10 years, the pension fund gained an 8.2 percent return on investments.

As we look to the future, we anticipate a continued upturn in the financial markets. We maintain confidence in our asset allocation strategy and the long-term recovery of the equity markets as well as the overall economy. A well-diversified investment portfolio managed by a highly professional investment staff and Board that are on the cutting edge in the investment arena should continue to aid our performance and result in continued strong gains in individual asset classes, as demonstrated during the 2002-03 fiscal year.

Continued positive investment performance will not happen however, if corporate malfeasance continues unchecked. We have, and will continue, to use our influence in building strong alliances

with other institutional investors to make Wall Street and Corporate America more open and honest in the marketplace. That is why we campaigned during the year for better corporate accounting, greater board independence, and stronger governance principles. In the health care area, we fought to restrain escalating costs by phasing in our Strategic Plan for Health, which focuses on delivering better value from health plans, hospitals, physicians, and prescription drug providers. Through hard bargaining we were able to reduce proposed 2004 health premium increases by half. In the area of cost containment, we will now be requiring our plan partners to identify and create disease management programs for the five most prevalent chronic health conditions.

We reached several milestones this year in our ongoing efforts to improve customer service and access to CalPERS information. We launched a new, consolidated Contact Center for both members and employers, resulting in more immediate service for our customers. A twice-monthly e-mail newsletter—*CalPERS eNews*—was also launched during the year.

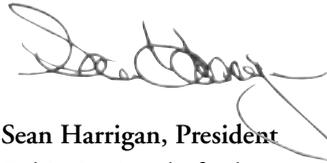
As we look ahead to 2004, several factors give us reason for considerable optimism. The economy is showing signs of improvement. The U.S. economy is growing at a faster and broader pace than in the past year and considerable investment opportunities still exist in both California and the nation. The Board and staff will continue to make prudent decisions in order to enhance returns on

our pension fund investments while minimizing employer contributions. We will seek innovative ideas to lower health care costs while improving the quality of the health care delivery system. We will provide additional education and training opportunities for our members and employers.

The year ahead holds tremendous promise. We enter it with a re-invigorated commitment to our core business areas—administering retirement and health benefits and meeting the needs of our members and our employers.

In closing, it must be noted that our strongest assets cannot be found on our balance sheet. Rather, it is found in the leadership of CalPERS and the more than 1,600 employees who continually strive to respond to the ever-increasing demand for customer services during challenging, rapidly changing times. Our success this year is a tribute to the entire CalPERS organization. We stand ready to provide this same level of quality service and dedicated commitment in fiscal year 2003-04.

Sincerely,

A handwritten signature in black ink, appearing to read "Sean Harrigan", written over a white rectangular area.

Sean Harrigan, President
CalPERS Board of Administration



Introduction

As the nation's largest public pension system, we are on the forefront of challenge and opportunity. We are entrusted with the trust funds of our more than 1.4 million members, who count on us every day to make wise investment and benefit decisions.

Within this Operations Summary you will find, illustrated through words and photos, not just our challenges but also our achievements and the progress we are making to ensure the retirement and health security of our members.

During the year, we stayed true to our strategic goals, and continued on a path toward achieving our business objectives. We made great strides in our customer service, benefits management, and asset management initiatives, while holding the line on our expenses. We maintained core workload levels, and enhanced our service to our members and employers. And while this past fiscal year continued to be challenging in achieving good investment returns and challenging in keeping our health care cost increases at bay, at all times, we kept our eye on the finish line—the long-term retirement and health security of our members.

Financial Highlights

Public Employees' Retirement Fund ¹

(Dollars in Thousands)

	2003	2002
Assets		
Cash & Cash Equivalents	\$28,465	\$20,537
Investments, at Fair Value	170,095,273	157,084,326
Receivables	2,370,550	5,604,611
Other Assets	169,751	123,820
Total Assets	\$172,664,039	\$162,833,294
Liabilities	\$27,901,333	\$20,046,076
Net Assets Held in Trust for Pension Benefits	\$144,762,706	\$142,787,218

Additions & Deductions

	2003	2002
Additions		
Member Contributions	\$1,887,925	\$2,154,742
Employer Contributions	1,925,044	800,964
Net Investment Income	5,474,084	(9,691,178)
Other	8,648	5,259
Total Additions	\$9,295,701	(\$6,730,213)
Deductions		
Retirement, Death & Survivor Benefits	\$6,991,914	\$6,431,019
Refunds	114,025	103,386
Administrative Costs	214,274	222,561
Total Deductions	\$7,320,213	\$6,756,966
Decrease in Net Assets Held in Trust for Pension Benefits	\$1,975,488	(\$13,487,179)

Complete financial information on all the funds administered by CalPERS can be found in the Comprehensive Annual Financial Report for the year ended June 30, 2003.

NOTE:

¹ Differences in the amount shown for investment assets in these Financial Highlights and the Investment Portfolio amount reported in the Investments Section of this summary are due to differences in reporting methods. In accordance with Governmental Accounting Standards Board Statement No. 28, the financial statements include Securities Lending Collateral. In addition Net Investment Receivables/Payables are not included here.



Back row standing: Steve Westly. Front row seated, left to right: Mike Quevedo, Jr., Ted Eliopoulos (representative for Philip Angelides), and Charles P. Valdes.



Back row standing, left to right: Robert F. Carlson, Sidney L. Abrams, Willie L. Brown and Kurato Shimada. Front row seated, left to right: Sean Harrigan, Rob Feckner, Marty Morgenstern, Priya Mathur, and George Diehr.

CalPERS Board of Administration

Sean Harrigan, President

State Personnel Board Member
(designated by the State
Personnel Board)

*Term Ends: Serves at the pleasure
of the State Personnel Board*

Rob Feckner, Vice President

Employee Member
(elected by school members)
Glazing Specialist, Napa Valley
Unified School District

Term Ends: January 15, 2007

Sidney L. Abrams

Official of Life Insurer ¹
Trustee, United Food and
Commercial Workers Unions
and Employers Midwest Health
Benefits Fund and Pension Fund

Term Ends: January 15, 2005

NOTES:

¹ Governor appointee.

² Appointed jointly by the Speaker of the Assembly and the Senate Rules Committee.

Philip Angelides

State Treasurer
Ex Officio Member

Willie L. Brown, Jr.

Elected Official of Local
Government ¹

Mayor of San Francisco

Term Ends: January 15, 2007

Robert F. Carlson

Retired Member
(elected by retirees)
Retired, Chief Counsel,
Department of Transportation

Term Ends: January 15, 2008

George Diehr

Employee Member
(elected by State members)
Professor, CSU San Marcos

Term Ends: January 15, 2007

Priya Mathur

Employee Member
(elected by public
agency members)
Economist, Bay Area
Rapid Transit

Term Ends: January 15, 2007

Marty Morgenstern

Director, Department of
Personnel Administration
Ex Officio Member

Mike Quevedo, Jr.

Public Representative ²

Term Ends: January 15, 2004

Kurato Shimada

Employee Member
(elected by all members)
Retired, Supervisor of Operations,
Oak Grove School District

Term Ends: January 15, 2006

Charles P. Valdes

Employee Member
(elected by all members)
Counsel, Department
of Transportation

Term Ends: January 15, 2006

Steve Westly

State Controller
Ex Officio Member

CalPERS Board Committees

In addition to their regular duties, Board Members also serve on permanent and ad hoc committees to review specific programs, projects, or issues and make recommendations to the Board. The following committees were active as of June 30, 2003.

Benefits & Program Administration

Kurato Shimada, Chair	Sean Harrigan
Sidney L. Abrams, Vice Chair	Priya Mathur
Robert F. Carlson	Marty Morgenstern
George Diehr	Steve Westly
Rob Feckner	

This committee reviews all matters related to benefit program structure, actuarial studies and rate setting, retirement program policy, and administrative issues.

Health Benefits

Sidney L. Abrams, Chair	Priya Mathur
George Diehr, Vice Chair	Marty Morgenstern
Philip Angelides	Charles P. Valdes
Rob Feckner	Steve Westly
Sean Harrigan	

This committee oversees the administration of the Public Employees' Medical & Hospital Care Act program and the Public Employees' Long-Term Care Act program.

Performance & Compensation

Charles P. Valdes, Chair	Priya Mathur
Robert F. Carlson, Vice Chair	Kurato Shimada
George Diehr	Vacancy
Rob Feckner	

This committee studies and evaluates compensation mechanisms and criteria, develops policies and procedures, and makes recommendations to the Board concerning compensation of key personnel.

Finance

Robert F. Carlson, Chair	George Diehr
Steve Westly, Vice Chair	Priya Mathur
Philip Angelides	Charles P. Valdes
Willie L. Brown, Jr.	

This committee provides financial oversight on all budget matters, evaluates funding alternatives, oversees preparation and recommends approval of the CalPERS budget, and oversees the CalPERS annual and periodic audits by both internal and external audit units.

Investment

Rob Feckner, Chair

Priya Mathur, Vice Chair

Sidney L. Abrams

Philip Angelides

Willie L. Brown, Jr.

Robert F. Carlson

George Diehr

Sean Harrigan

Marty Morgenstern

Mike Quevedo, Jr.

Kurato Shimada

Charles P. Valdes

Steve Westly

This committee reviews investment transactions, the investment performance of both internal and external managers, and establishes investment policy and strategy.

Investment Policy Subcommittee

Charles P. Valdes, Chair

Philip Angelides, Vice Chair

Robert F. Carlson

This subcommittee conducts an inventory of all existing investment policies, procedures, and guidelines for review by the Investment Committee and reviews and recommends revisions to these on a priority basis. It is also charged with developing a manual of policies, procedures, and guidelines, and a process for periodic revisions.

R Street Subcommittee

Charles P. Valdes, Chair

Rob Feckner

Robert F. Carlson, Vice Chair

Kurato Shimada

Priya Mathur

This subcommittee oversees the CalPERS headquarters expansion project, including the selection of contractors, approval of building designs, and approval of expenditures and budgets.



Back row standing, left to right: Robert D. Walton, Peter H. Mixon, Allen Goldstein, and Mark J.P. Anson. Front row seated, left to right: Fred Buenrostro, Patricia K. Macht, Loren D. Suter, Barbara Hegdal, Ron Seeling, and Vincent P. Brown.

CalPERS Staff

Executive

Fred Buenrostro
Chief Executive Officer

Vincent P. Brown
Deputy Executive Officer
Operations

Loren D. Suter
Deputy Executive Officer
Benefits Administration

Mark J.P. Anson
Chief Investment Officer
Investment Office

Allen Goldstein
Interim Assistant
Executive Officer
Health Benefit Services

Barbara Hegdal
Assistant Executive Officer
Member & Benefit Services

Patricia K. Macht
Chief
Office of Public Affairs

Peter H. Mixon
General Counsel

Ron Seeling
Chief Actuary
Actuarial & Employer Services

Robert D. Walton
Assistant Executive Officer
Governmental, Administrative
& Planning Services

Vacant
Assistant Executive Officer
Investments Office
*Robert Aguallo through
January 2003*

Division Chiefs

Jack Corrie
Information Technology Services

Tom Fischer
Health Benefit Services

Holly Fong
Fiscal Services
*John Korach through
April 2003*

Tim Garza
Enterprise Modeling &
Management

Allen Goldstein
Change Management

Pat Harris
Branch Development Center

Linda Hoff
Office of Policy & Program
Development

Greg Hood
Investment Operations

Larry Jensen
Office of Audit Services

Ron Kraft
Customer Contact Center

Jeff Lung
Office of Information Security

Ken Marizon
Actuarial & Employer Services

Carol McConnell
Deputy General Counsel
Legal Office
*Peter H. Mixon through
November 2002*

Dave Mullins
Supplemental Savings Program

Rick Nelson
Operations Support Services

Karen Neuwald
Office of Governmental Affairs
Casey Young through
April 2003

Chris Nishioka
Benefit Services

Michael Ogata
Planning & Research

Tom Pettey
Human Resources

Diana Proctor
Headquarters
Expansion Project

Dan Schroepfer
Office of Long-Term Care

Kathie Vaughn
Member Services

Joyce Vermeersch
Health Program Development

Nancy Welsh
Health Self-Funded Programs

Regional Office Managers

Anita Commer
San Francisco

June Copple
San Bernardino

Laura Duran
Orange County

Elaine Edwards
San Diego

Debra Gibson
Sacramento

Edith Mercer
Glendale

Elwin Nash
Mountain View

Steve Pietrowski
Fresno



The Year in Review

In fiscal year 2002-03, CalPERS faced a force of challenges. State and local governments continued to strain under fiscal difficulties. Health care costs continued to rise, and the downturn in financial markets, investment scandals, and other problems all contributed to a continued weak recovery.

While we were continually tested, we did not fall behind in any of our major Strategic Plan initiatives. We kept to our mission—administering benefits, providing quality service, and prudently managing our assets. In most cases, we persevered and were able to realize our goals. However, the true measure of success was our ability to not only clear the hurdles set before us, but to emerge stronger as a result of them, and with the stamina needed to stay on course.

Managing Our Benefits

This past year, we continued our efforts to streamline and improve our benefits management. Staff raised the bar on customer service by working to implement more improvements to our business processes. For example, we improved the way staff administer disability determinations and community property settlements. Our service credit costing staff completed 90 percent of their requests in 30 days.

We improved our Customer Contact Center with new features designed to hasten service. We continued our efforts this year to stay abreast of the benefits industry. Our Policy and Program Development Office kept us up to date with industry trends, conducted retirement plan studies, and coordinated and analyzed State and federal laws for their impact on our programs.

We continued to break records for managing our core workload. Staff processed 20,117 new service retirements and paid out nearly \$7 billion in retirement, death, and survivor benefits, up from \$6.4 billion the previous year. And a total of 97 percent of our newly-retired members received their first benefit check within 30 days of their retirement date. In addition, we processed 24,774 requests for refunds and got those refunds to members within 30 days. Staff also completed 3,872 disability retirement determinations and processed 45,529 requests for direct deposit of retirement checks.

We also processed a record number of retirement estimates—completing more than 80,000 retirement estimates. We completed more than 28,000 service credit cost calculations, and processed 14,477 service credit elections. We provided assistance and counseling services to 51,760 visitors who came to one of our eight Regional Offices. We held 652 retirement sessions at employer sites, and conducted nearly 1,600 financial planning seminars and retirement planning workshops.

Providing Customer Service

One of our key core objectives is simple: provide high-quality customer service. A cornerstone of service is a state-of-the-art Customer Contact Center. Our Center acts as the initial point of contact for telephone inquiries from active and retired members and employers on multiple topics. This year, we made enormous progress toward this goal with more enhancements. We launched a consolidated toll-free telephone number for all customer service calls—CalPERS members and employers—(888) CalPERS (225-7377).

CalPERS members and representatives of contracting employers can call one easy-to-remember number for assistance. Members are first greeted by our Interactive Voice Response (IVR) System, which routes member calls to our Customer Contact Center and employer calls to our newly-created Employer Contact Center. When needed, customers will be referred to specially-trained agents to answer questions and provide assistance. When an issue is especially complex or technical, the call will be referred to a staff expert for assistance. Every effort is made to assist the caller during the initial contact, resulting in more immediate service.

We have further improved the self-service nature of our telephone system, as well. The IVR accommodates those who want publications or to listen to frequently asked questions or special announcements on topics such as the issue date of benefit checks, refunding member contributions, or purchasing service credit.

Our telephone service is just one communication channel in which members can conduct CalPERS business. We continued to interact with members through our expanding Web site online services. During the year, well over 30 million visits were made to our Web site. The most popular aspects of our Web site continued to be services such as signing up for a retirement workshop or financial planning seminar, or calculating their own retirement estimate.

In November 2003, we launched another online service, Change Your Address, which allows members to change their mailing address right from their computer. This service joined our growing menu of online services such as requesting official CalPERS retirement estimates, registering for a seminar or workshop, and ordering publications, forms, or a CalPERS video online.

Members can also view their Annual Member Statement, use the Retirement Planning Calculator (which can automatically add personal account information), and the Service Credit Cost Estimator.

Retirement Program Highlights

- **1,014,360** active & inactive members
- **396,151** retirees, beneficiaries & survivors
- **20,117** new retirees
- **\$6.9 billion** paid in benefits
- **1,483** public agency employers (including school districts)

During the annual Health Open Enrollment Period, we also have a service that allows retirees to make a health plan change online. All our online services are offered in a secure environment and most require members to register for a password to ensure protection of their electronic information.

Our electronic classroom on retirement topics has been extremely popular as well. Known as the Online Financial Planning Center, it provides five different financial planning courses from cash and risk management to determining their investment type and developing investment strategies. Members can also find help on estate, insurance, and retirement planning. To request a personal financial plan, members can also contact a financial advisor online.

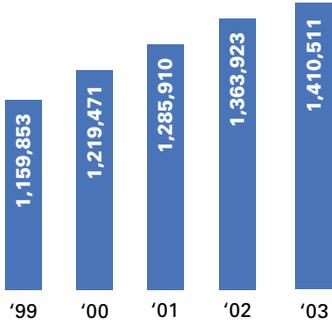
We also entered into the instant news business, by introducing another new channel of communication—*CalPERS eNews*—a bimonthly e-mail newsletter available by subscription to members, employers, and other interested parties who want breaking news on CalPERS programs.

Each year, we take great pride in hosting Retirement Planning Month—an event held to educate members about the value of their CalPERS defined benefit plan, their Social Security benefits, and their options for growing their own personal savings. This year’s event featured open houses at each one of our eight Regional Offices located throughout the State. More than 2,000 visitors attended these events.

In addition, members had an opportunity to talk with our financial education advisors, American General Financial, to further assist them with their retirement planning. Each visitor received a special retirement planning calculator and a portfolio to keep all their important CalPERS information. Members were able to meet with our staff and talk about their retirement benefits and financial planning opportunities, and to learn more about our other programs and services, such as our Member Home Loan and Long-Term Care Programs. We also had special information for our retired members, since secure financial planning does not end at retirement.

Total CalPERS Membership

Five-Year Review



CalPERS Supplemental Savings Program

The CalPERS Public Agency 457 Deferred Compensation Program, which is available to local public agency and school members, welcomed an additional 2,958 new participants and 40 new agencies this past fiscal year. The program now has almost 16,000 members and 454 participating employers. Assets totaled \$279.6 million at year end, a 23.4 percent increase from the previous year. Contributions received were \$70.1 million and distributions and withdrawals paid to participating plan members were \$20.4 million.

The State Peace Officers' and Firefighters' Defined Contribution Program realized plan growth for its 34,000 participants. This employer-paid program is available to certain eligible State safety members. Net assets increased by 36.5 percent to \$134.7 million at June 30, 2003. Benefits paid out during the year were \$4.1 million, and contributions increased 2.6 percent to \$35.0 million.

The CalPERS Supplemental Contributions Program is a voluntary supplemental savings scheme available to State members and is entirely member funded. Contributions are made after-tax basis. At the end of fiscal year 2002-03, there were 1,041 participants and assets were valued at \$18.4 million. Contributions were \$0.6 million for the year, and \$1.7 million was paid in participant withdrawals.

CalPERS Member Home Loan Program

This innovative home loan program is administered by more than 40 lending institutions with nearly 927 branch locations in the State and across the nation.

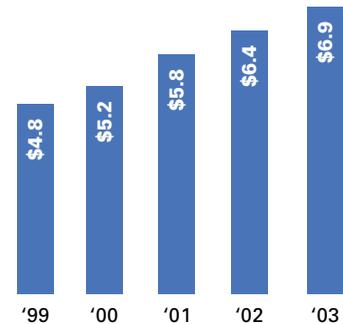
We don't make home loans directly to our members. Instead, we purchase the loans made by the lending institutions. We make the process of getting a mortgage faster, easier, and more affordable than ever before.

The Program offers CalPERS members competitive loan rates, a free 60-day interest rate lock, and a 100 percent financing option. There are also several options to help first-time buyers and low- to moderate-income purchasers. By reducing traditional mortgage

CalPERS Benefits Paid

Five-Year Review

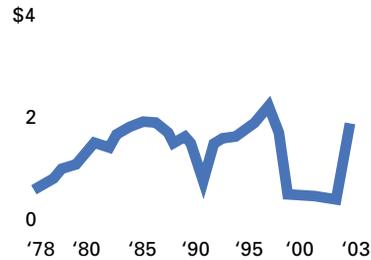
(Dollars in Billions)



CalPERS Income from Employer Contributions

25-Year Review

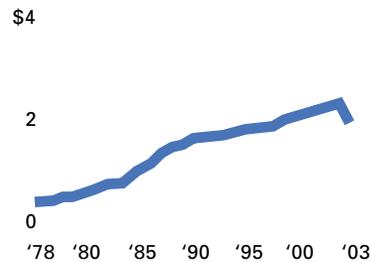
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CalPERS Income from Member Contributions

25-Year Review

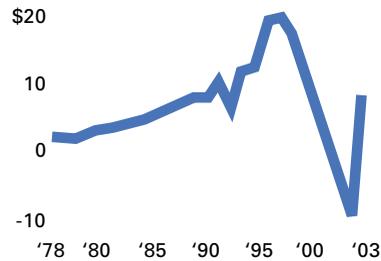
(Dollars in Billions)



CalPERS Income from Investments

25-Year Review

(Dollars in Billions)



lending barriers, lowering costs, and increasing the opportunities for homeownership for members, we will strengthen our members' families, communities, and our State as a whole.

During the year, the Program purchased 14,463 real estate loans totaling more than \$2.6 billion, and 1,275 personal loans of \$11.7 million.

Increasing Employer Satisfaction

The third annual CalPERS Educational Forum—Working Toward Solutions—provided an excellent opportunity to strengthen relationships with our employers who assist CalPERS in administering benefits to their employees. The Forum took place at the Sacramento Convention Center in October and was attended by more than 640 employer representatives.

This year's Forum focused on our continued efforts to improve services to meet our employer's ever-increasing needs. We designed our workshops to generate discussion and provide an opportunity for employers to make suggestions on how we can improve or develop new services. Topics focused on three areas: daily administration—covering important issues such as Social Security and reporting for schools and public agencies; future direction—providing employers with information to assist them in their visionary efforts as they plan for the future of their organization; and helping employees—presenting the latest educational information and tools.

During the year, staff was proactive in reaching out to employers, providing them with training and education on CalPERS business. More than 1,000 employers received our Automated Communications Exchange System (ACES) training through 90 educational sessions held throughout the State. Staff also conducted 55 school and public agency workshops to 264 employers reaching more than 800 attendees. Employer education for State agencies and the California State University (CSU) System was rolled out to the State of California's five largest departments: Department of Forestry, Department of Motor Vehicles, Employment Development Department, Department of Transportation, and the Department of Corrections (including all 33 State correctional facilities from Pelican Bay in Del Norte County to Calipatria State Prison in Imperial County). In addition, we presented a CSU education seminar at the annual California CSU Benefit Officers Workshop, where additional State agencies and departments were invited to participate. Nearly 1,000 attendees, representing 102 State agencies, benefited from the workshops.

This year, we distributed more than 2,700 copies of the first edition of our *CalPERS State Handbook*. This important educational tool provides our State and CSU employers with a basic understanding of our policies, procedures, and processes.

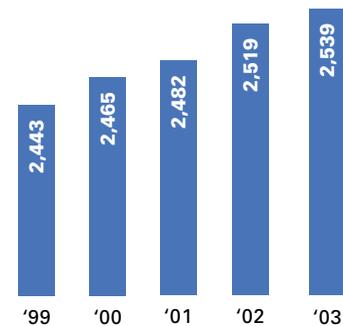
ACES, which allow employers to submit electronic health benefit, membership, and payroll transactions via the Internet, continued to

expand with 552 new participating employers. This online business system reduces the volume of paper CalPERS receives, improves the timeliness and accuracy of employer transactions, and results in reduced time for members to receive benefits.

Staff also completed and mailed 1,906 public agency annual valuation rates on schedule, processed more than 178,000 member transactions submitted by employers, 40,000 payrolls, and completed 1,944 member record compensation reviews. In addition, staff processed more than 400 benefit provision changes through public agency contract amendments.

CalPERS Participating Public Agencies

Five-Year Review



We also took aggressive steps to help reduce rate fluctuations facing small employers by sponsoring legislation to permit risk pools. The pooling of plans across employers will result in greater rate stabilization, as well as improved customer service. Also, risks associated with small asset/liability pools will be mitigated. We proposed nine risk pools: five for miscellaneous risk pools and four for safety.

We continued to focus on customer service as a high priority for employers too. As a result of feedback received from our employer survey, we took steps to improve telephone services by creating our Employer Contact Center (ERCC). Most employer services are now centralized and consolidated in the new ERCC. Employers can call one toll-free number for all their CalPERS business. Our specially-trained agents can answer questions or assist employers with their CalPERS business transactions.

Improving Our Organization Effectiveness

We recognize that our future success will, in part, hinge on our ability to harness technology. Ongoing development of new products and improving the effectiveness and efficiency of existing technology will enable us to accomplish complex tasks faster and more easily. This will make it possible for us to deliver quality service to our members and employers well into the future.

During the year, we implemented a Fixed Income Trading System (FITS) for all fixed income investments, both internally and externally

managed. FITS enables us to automate and streamline our business processes, helps staff be more effective in making decisions about investments, and ultimately makes it possible to save millions of dollars a year. Another ongoing investment project—Straight Through Processing—will enable us to automate many manual processes and increase operational efficiencies during our trading and settlement.

Information security is critical and is a top priority at CalPERS. Within our organization, we have a special CalPERS team that is specifically devoted to this function so we can ensure all our information assets are protected and member personal information remains secure. This past year, through the efforts of our employees, and with the help of anti-virus software, more than 337,000 viruses were prevented from invading our computer systems.

In addition, member assets are protected through the internal and field audit programs undertaken at CalPERS. Through the Office of Audit Services, we can be assured that our programs, policies, and other legal requirements are met across the board. During the year, our auditors completed 48 public agency audits, provided consultations on 23 more projects, conducted 28 internal audits, and completed 14 health plan and real estate compliance audits.

CalPERS is a major source of contracts for many businesses. To ensure that our procurement processes are widely known by the business community we formed the CalPERS Business

Connection, an aggressive outreach and marketing program geared toward potential business partners. Our CalPERS On-Line Web site now lists all current available business opportunities and helps keep interested businesses in the know, so they can bid on these contracts.

Our small business participation levels doubled to 12.7 percent of CalPERS overall contract volume, and through the efforts of the Business Connection Program and our Procurement and Asset Management section, we realized a tenfold increase in Disabled Veteran Business Enterprise participation levels.

The CalPERS Strategic Plan would not be a success without the people to carry it out. Our achievements are attributed directly to the expertise and dedication of our employees. We have a highly-motivated, diverse team of professionals committed to furthering CalPERS vision.

CalPERS continued to be a destination employer, a workplace that attracts and retains high performing staff. We focused on training our leaders of tomorrow and offered staff six foundational courses that cover the knowledge essential for success as a CalPERS employee. In our onsite Learning Center, staff can utilize more than 1,100 video- or audio-based courses, or register for computer-based training, as well as external training opportunities. In addition, 225 of our senior management team, program managers, and first-

line supervisors completed a 360-degree Leadership Feedback Program series. Through this program, executives and managers were provided with the needed knowledge and skills to lead and inspire their staff.

At CalPERS, we believe in not only helping our members, but also helping the community we live in as well. Staff made charitable contributions of nearly \$140,000, up by 6 percent from the previous year, donated more than 108,000 pounds of food to the State Employee Holiday Food Drive (the highest amount ever donated by any State agency). We surpassed the previous year by 31 percent and donated 434 pints of blood with our various blood drives throughout the year.

Headquarters Expansion

Work is progressing at a steady pace on our Headquarters Expansion Project and remains on schedule for completion in 2005. The mixed-use complex, adjacent to our existing building will include a building with a six-story west wing and a four-story east wing, an 18,000-square foot public courtyard, parking, retail shops, a restaurant, and the relocation of our day care center. The office space will provide room for our staff as CalPERS continues to grow to meet our member needs. It will also make a significant contribution to the Sacramento community, creating a neighborhood that connects work and living spaces in a way that improves the city.

Feedback & Recognition

At a ceremony held in May 2003, 28 CalPERS employees were honored as the 2003 APEX nominees. The APEX (Achieving Performance Excellence) is our peer-driven formal recognition program that acknowledges those employees who demonstrate commitment to the CalPERS core values, our customer service principles, excellent technical and interpersonal skills in ongoing pursuit of self-development, and to the overall success of CalPERS.

In addition, *Oracle Magazine* recognized the CalPERS Information Technology Services Division Chief as CIO of the Year in their 2002 Editors' Choice Awards, and our Planning and Research Division's Librarian received the Special Libraries Association's Member of the Year Award.

As an organization, the California Disabled Veteran Business Enterprise (DVBE) Alliance presented CalPERS with three Special Recognition awards for substantial improvements to our DVBE program. In the last fiscal year, nearly \$4 million of CalPERS total contracts were made through certified DVBE companies.

And finally, CalPERS is especially proud to receive another "Certificate of Achievement for Excellence" for Financial Reporting from the Government Finance Officers this past year.



CalPERS Health & Long-Term Care Report

On Course for Long-Term Value

Fiscal year 2002-03 marked a turning point in purchasing health care benefits for CalPERS members. This was the year that we embarked on a new strategic direction, a long-term change in direction on how we will approach purchasing health care services for our more than 1.2 million members. The plan is our blueprint for long-term savings, improved quality and choice, and Health Program stability. We also simplified our annual open enrollment process and created CalPERS-dedicated customer service units with our health plan partners. Our self-funded health plans continued to build their financial reserves and received positive feedback on a new pharmacy benefit administrator. New constituent advisory panels were developed during the year that are helping us better address the needs of public agencies and school employers. Our Long-Term Care Program also continued to add enrollees and build fiscal stability.

Health Program Highlights

- **1,240,595** employees, retirees & family participants
- **60 percent** are State members
- **40 percent** are public agency & school members
- **\$3.4 billion** paid in annual health premiums

Gains in a Tough Market

Our Health Program faced a formidable challenge at the start of the fiscal year. Our immediate need was to restrain escalating costs, our strategic imperative was to address the root causes of health care inflation.

As the year began, nationwide health care prices were still soaring with no relief in sight. Our enrollees were older, and many of them had costly chronic conditions and were requesting new diagnostic and treatment technology. Hospital prices were up. Prescription drug manufacturers were hawking expensive brand name products on TV to receptive audiences and, our enrollees still faced substantial premium increases for the 2003 calendar year.

In fiscal year 2003, members in Basic plans paid on average 25.9 percent more for the services of health maintenance organizations (HMOs), 19.9 percent more for the self-funded preferred provider organizations (PPOs), PERSCare and PERS Choice, and 20.8 percent more for three association plans for public safety officers. Medicare Supplement plan coverage would increase by 40.6 percent for HMOs, 5.8 percent for PPOs, and 18.8 percent for Associations.

Our health premium costs during 2003 totaled an estimated \$3.4 billion, compared with \$2.7 billion in 2002. That total would have been \$77 million higher had we not eliminated Health Net and PacifiCare, which had demanded premium increases approaching 35 percent.

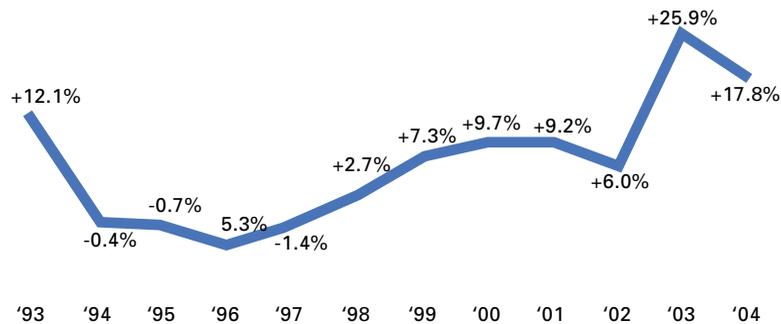
Two other HMOs also left the Program in 2003. Health Plan of the Redwoods filed for bankruptcy and Universal Care withdrew. Blue Shield of California, Kaiser Permanente, and Western Health Advantage remained in the Program on the HMO side, while Blue Cross and Caremark administered the medical and pharmaceutical benefits for the PPOs.

The consolidation of HMO partners from seven to three led to a record number of plan switches in 2003, when 360,000 enrollees changed plans to joined Blue Shield. We teamed with our health care plan partners to process nearly 294,000 Open Enrollment transactions—in addition to another 156,000 daily transactions.

Basic HMO Premium Averages

Percent Decrease or Increase

Based on a weighted average of all CalPERS HMOs



New Strategic Plan Sets Direction for Change

As the nation's third-largest purchaser of public employee health benefits, we cannot afford to wait for better trends to develop, so we are working on enduring solutions for what has become a national crisis. We need to fine-tune measures aimed at restraining costs and improving access, plan stability, and the effectiveness of care—even as rates continue skyward.

The HMO consolidation set the starting block to initiate our Strategic Plan for Health during negotiations for the 2004 coverage year. While reducing our lineup to three HMOs in 2003 may have appeared to reduce member choice, almost 90 percent of the members who switched plans retained their primary care doctors. Consolidation of HMO partners also enabled us to meet our three other policy imperatives: to restrain costs, improve the Program's stability, and enhance efforts to deliver more high-quality, cost-effective care.

In Spring 2003, our Board adopted the Strategic Plan for Health and assured improved stability by authorizing multi-year contracts with HMOs, beginning with Blue Shield. Our largest HMO partner, Blue Shield, with some 460,000 enrollees, was the ideal candidate for an extended partnership.

We estimate that the multi-year contract will account for about half of the \$260 million averted in initial HMO bids. A pricing

mechanism for 2005-06 provides that costs below agreed-upon premium targets would be reflected in future year rate savings, or in future rate increases if actual costs exceed the targets.

Premium Trend Relief

During premium negotiations, there were signs that the rate of increase in nationwide prices was leveling off when it came to hospitals, medical groups, and pharmaceutical providers. Overall, the negotiated 2004 premium increases were only about half the 31 percent rate hike initially sought by HMOs.

For 2004, premiums for Basic plans will increase by 17.8 percent for HMOs, 13.2 percent for PPOs, and 11.6 percent for Associations. Medicare Supplement plan premiums will rise by 26.8 percent for

HMOs, decline 1.2 percent for PPOs, and increase 15.0 percent for Association plans.

The rate package was in line with what analysts forecast for other employer-based purchasers in 2004, many of whom have younger, healthier enrollees than ours.

PPOs Report Gains

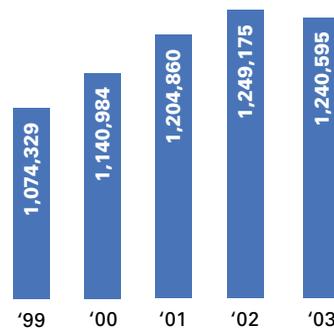
PERSCare and PERS Choice reached a major milestone in January 2003 by smoothly transitioning more than 285,000 members from the plan's previous pharmacy benefits administrator to Caremark. A high proportion of members found the transition information they received and Caremark customer services helpful. Caremark offers robust clinical programs directed at improving the quality of care that members receive and managing drug costs.

The self-funded plans reserves increased by \$90 million, enhancing member security and strengthening the plan against volatilities in the health care marketplace.

The plans added new health improvement programs designed to reach out to members at risk of cardiovascular disease and diabetes. They also offered depression screening and a leading-edge "predictive modeling" program designed to identify at-risk members who would not otherwise be identified through traditional assessments.

Total Health Program Membership

Five-Year Review



Blue Cross, the administrator, agreed to implement a provision of the Strategic Plan for Health by expanding its “Centers of Expertise” program. In 2003, the program had limited transplant surgeries only to those network hospitals that met industry-wide performance standards. In 2004, preferred hospitals will be similarly designated for coronary artery bypass graft procedures.

The “Value Proposition”

By directing more of our members to the best providers, we hope to restrain costs that vary as much as 65 percent across the State, depending on the hospital. Since hospitals, physicians, and pharmaceuticals account for up to 90 percent of our Program expenditures, their pricing and treatment practices have emerged as logical targets for our efforts.

We endorsed State legislation to require more thorough reporting of hospital costs so we can track where employer and member health dollars are going. The Blue Shield HMO plan has already provided us the most complete HMO information about our members’ cost and treatment to date, and Kaiser also was more forthcoming than in previous years.

Gathering such information will be especially critical given the emerging role of our new high-tech tool to track costs. Coming in January 2004, the Health Care Decision Support System, or data warehouse, is envisioned to be the cornerstone of our effort to track the enrollee experience and assure better value.

The tool will enable us to get the information and analysis we need to better negotiate premiums, model potential new services, measure the effectiveness of care management programs, and investigate new benefit design and health products.

Constituent Coalition & Legislative Efforts

During the year, we began work on a task force to address the problem of rural health care access, and on collaborative ventures with other states and purchasers to rein in costs and improve the value of prescription drugs—possibly through the formation of coalitions.

To engage public agencies, we launched an outreach effort to thousands of cities, counties, school districts, and special districts that were not among the some 1,100 public agencies already in our Program receiving our health benefits. As the fiscal year ended, 28 agencies had joined the Program since January 1, 2003.

On the legislative front, we supported federal initiatives and State bills requiring hospitals to be more accountable in reporting their costs and providing coverage to more uninsured or under-insured working Californians. We sponsored successful legislation to give the Health Program more flexibility in benefit designs for public agencies, and in using regional rating should the Board adopt such options.

Gains for Service & Quality of Care

In Spring 2003, we asked our enrollees about the customer service they receive from their plan, while we compiled effectiveness of care measurements for collaborating health plans. The annual Quality Report that emerged from those two assessments showed that most plans had improved the quality and effectiveness of care they offered.

The CalPERS Long-Term Care Program

Our popular Long-Term Care Program gained more than 7,500 enrollees during the 2002-03 fiscal year. Almost 173,000 people were in the Program at year end, paying annual premiums of approximately \$202.9 million and receiving more than \$41.1 million in benefits. For the first time since the Program began in 1995, we increased premiums to compensate for shortfalls in investment returns, and adopted policies aimed at keeping the Program on solid fiscal ground into the future.

Long-term care covers personal, non-medical assistance in performing ordinary activities of daily living, such as bathing, dressing, toileting, transferring to and from chairs, beds, or wheelchairs, eating, and continence.

Our Program provides three plan options: a Comprehensive Plan, a Facilities Only Plan, and a Partnership Plan. The Comprehensive Plan covers care at home or in the community, an assisted living facility, or a nursing home. The Facilities Only Plan covers care in a

nursing home or assisted living facility, and the Partnership Plan covers home and community care, assisted living, and nursing home care with a MediCal asset protection feature. Each plan includes care advisory services, respite care to provide short-term relief to normal caregivers, a premium waiver while receiving benefits, portability, inflation protection options, guaranteed renewal from year to year, and hospice care.

At the close of the fiscal year, 73.1 percent of all enrollees were in the Comprehensive Plan; 22.5 percent were enrolled in the Facilities Only Plan; and 4.4 percent were in the Partnership Plan. Some 72.4 percent of enrollees had chosen automatic inflation protection.

Although many companies provide for long-term care coverage, CalPERS offers the nation's first self-funded, not-for-profit long-term care program, with plans that are very competitive with the commercial marketplace. Premiums are paid by the individual and are based on their age when the application is received. Benefits are tax free, and portions of the premiums paid may be tax deductible under certain

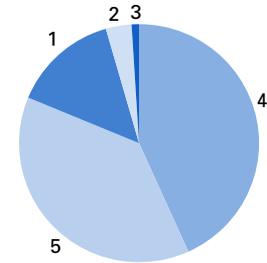
Long-Term Care Program Highlights

- 172,680 participants
- \$1,213 is average annual premium
- \$202.9 million in annual premium income
- \$41.1 million paid in benefits

circumstances. The total coverage amount applies to all covered services, so members can use their benefits in whatever combination best meets their needs under the plan they choose. In addition, the deductible period is counted in calendar days—not days of paid service, enabling members to save potential out-of-pocket expense.

LTC Program Membership

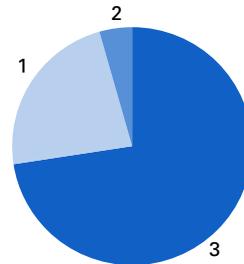
- 1. Active Employee Spouses - **14.5%**
- 2. Parents - **3.8%**
- 3. Siblings - **0.3%**
- 4. Active Employees - **44.0%**
- 5. Retirees & Spouses - **37.4%**



LTC Membership

by Plan Type

- 1. Facilities Only Plan - **22.5%**
- 2. Partnership Plan - **4.4%**
- 3. Comprehensive Plan - **73.1%**





CalPERS Investments

Strong Investment Performance Breaks Downward Cycle

CalPERS delivered positive performance returns during the fiscal year, despite a dampened market. Our return on investments was 3.7 percent for the one-year period ended June 30, 2003, generating more than \$5 billion in investment income. The Fund ended the year with assets of \$144.8 billion.

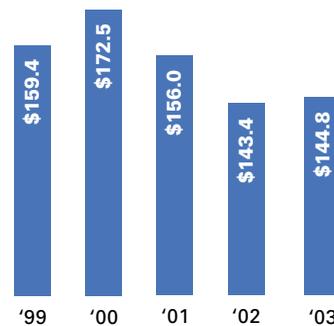
Our performance ended a two-year run of negative returns and demonstrated a turning point in the markets. Despite a rough two years, we remained confident in the strategic asset allocation

Growth of Investment Portfolio

At Market Value

Five-Year Review

(Dollars in Billions)



decisions made by the CalPERS Board and confident in the long-term return of the equity markets and the economy. A well-diversified investment portfolio and strong gains in individual asset classes aided our investment performance.

The positive gain for the fiscal year strengthened our long-term performance. Annually compounded over the past 10 years, our investment portfolio returned 8.2 percent through June 30, 2003. The 15-year return rate of 9.6 percent exceeded our 8.25 percent assumed actuarial rate of return.

Performance Benchmarks

<i>Asset Class</i>	<i>Benchmark</i>
Global Fixed Income	Citigroup Large Pension Fund Index Citigroup Non-U.S. Government Bond Index (Net Italy Tax)
Equity	
Domestic	PERS Wilshire 2500 Index (Tobacco-Free Index)
International	PERS SSGA Custom
Alternative Investments	15 Percent Hurdle Rate
Real Estate	NCREIF Property Index

Our U.S. and international fixed income portfolio bounced back last year, with our global fixed income portfolio earning a 16.9 percent return, beating the 15.5 percent returned by the customized benchmark. The outperformance was due to good securities selection and sector allocation by the System's fixed income investment staff.

Our U.S. stocks, which are largely passively managed in an index fund, beat the index and returned 1.4 percent versus the Wilshire 2500 Index (Tobacco-Free Index) that returned 1.1 percent. International stocks lost 7.5 percent of value, while our real estate investments returned 5.1 percent versus the 7.7 percent gain turned in by the NCREIF Property Index.

CalPERS Asset Allocation

<i>Asset Class</i>	<i>Market Value (\$ Billion)</i>	<i>Current Allocation</i>	<i>Current Target ¹</i>	<i>Previous Target</i>
Cash Equivalents	\$3.2	2.2%	0.0%	1.0%
Global Fixed Income	\$37.9	25.8%	26.0%	28.0%
Equity				
Domestic	\$58.5	39.8%	39.0%	39.0%
International	27.6	18.8	19.0	19.0
Alternative Investments/Private Equity	7.4	5.0	7.0	6.0
Total Equity	\$93.5	63.6%	65.0%	64.0%
Total Real Estate	\$11.6	8.4%	9.0%	8.0%
Total Fund	\$146.2 ²	100.0%	100.0%	100.0%

NOTES:

¹ Target allocation effective January 1, 2003.

² Differences between investment values above and the values on the Summary of Investments on page 73 of the CAFR are due to differences in reporting methods. The Summary of Investments includes Net Investment Receivables/Payables.

Our private equity and venture capital investments still returned \$339 million in investment income and fared better than the overall private equity market, despite posting a loss of 10.6 percent. According to data released by Venture Economics, private equity investments in the U.S. lost 18.5 percent in the first nine months of the 2002-03 fiscal year.

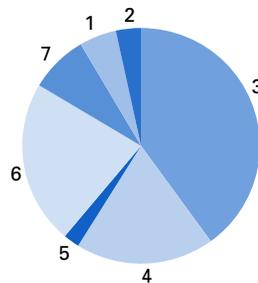
Allocation of Investment Portfolio

at Market Value

\$146.2 Billion ¹

(Dollars in Billions)

1. Alternative Investments & Private Equity - **\$7.4**
2. International Fixed Income - **\$5.0**
3. Domestic Equity - **\$58.5**
4. International Equity - **\$27.6**
5. Cash Equivalents - **\$3.2**
6. Domestic Fixed Income - **\$32.9**
7. Real Estate - **\$11.6**



NOTE:

¹ Differences between investment values above and the values on the Summary of Investments on page 73 of the CAFR are due to differences in reporting methods.

At the year end, U.S. and international stocks represented approximately 58 percent of CalPERS assets; U.S. and international bond investments 26 percent; real estate 9 percent; and private equity investments 7 percent of assets.

Investment Policy & Strategy

Asset allocation is one of the most important decisions made by the CalPERS Board of Administration. In the long run, it is the way in which we diversify stocks, bonds, real estate, and other investments that determines our long-term performance. Studies have shown that approximately 95 percent of the variation in investment performance of a pension plan is attributable to the asset allocation policy.

The asset allocation plan is the working framework for the selection and weighting of asset classes. The CalPERS Board sets a strategic asset allocation policy and a range around the target allocations. The allocation reflects that long-term outlook for each asset class. Our Board sets tactical asset allocation ranges that enable investment managers to take advantage of buying or selling opportunities and provides the flexibility for day-to-day management.

The CalPERS asset allocation mix is decided following an extensive review of a variety of factors. Economic scenarios of the global financial markets are simulated and future liabilities and expected future contributions by employers are considered.

CalPERS Investment Performance Goals

In addition to setting overall asset allocation policies, the Board also establishes investment policies for each portfolio and annual performance benchmarks for each asset class. Investment policies are formally reviewed through the Board's Investment Policy Subcommittee and receive final approval by the Investment Committee. Our investment policies can be found on our Web site.

Alternative Investment Management (AIM) Program

Our private equity investments, known as the CalPERS Alternative Investment Management (AIM) Program, delivered strong early returns, generating \$339 million in cash profit during the past 12 months.

Maintaining a high level of investment discipline and strengthening our existing portfolio became our primary focuses during the year. We improved our monitoring function to help us detect and resolve problems. We strengthened our relationships with existing partners and explored new portfolio management techniques. We took a leadership role in advancing industry-wide standards by working closely with the Institutional Limited Partners Association.

During the year, we became the first U.S. public pension fund to adopt a comprehensive performance disclosure policy for private

equity investments. Our goal was to provide the highest level of transparency that would not conflict with our fiduciary duty to our members—to maximize investment returns. We initiated extensive discussions on the subject with leading industry participants, the general partner community, prominent private equity advisors, and industry groups.

A Closer look at AIM

Investments & Commitments
(Dollars in Millions)

<i>Portfolio Strategy</i>	<i>Market Value</i>
Corporate Restructuring	\$3,144.1
Distressed Securities	524.7
Expansion Capital	1,304.7
Mezzanine Debt	348.9
Secondary Interests	273.7
Special Situation	346.9
Venture Capital	1,337.7
Other	99.6
Total	\$7,380.3¹

NOTE:

¹ Differences between investment values above and the values on the Summary of Investments on page 73 of the CAFR are due to differences in reporting methods.

The consensus was that transparency of individual fund performance would not be detrimental to investment results, but that portfolio company data are trade secrets, which if disclosed could create a market disadvantage for the specific funds. With that in mind, we launched a comprehensive performance information area on our Web site where we publish quarterly internal rate of returns for our funds and fund of funds, and the amounts of cash invested and profits realized.

Overall, AIM has earned CalPERS \$4.7 billion in cash profits—or a 9.0 percent return—since the first investment was made in 1990. The earnings come from \$6.5 billion currently invested, but CalPERS and its private equity partners have \$7.8 billion that will be deployed in the market over the next several years.

Despite economic weaknesses in the markets, we believe our private equity portfolio is well diversified across sectors. The next few years offer tremendous opportunity for this portfolio. We can expect that some of the greatest opportunities will come from technology growth in California and the U.S., and buyout strategies in Europe.

Real Estate

CalPERS retail and housing portfolios led the way with stellar performance during the year. Our retail assets earned a 17.0 percent return for the one-year period, while our housing portfolio generated a 28.3 percent return for the Fund.

A Closer Look at Real Estate

Investments & Commitments (Dollars in Millions)

<i>Portfolio</i>	<i>Fair Market Value</i>
Core Real Estate	
Office	\$2,584.8
Industrial	2,732.7
Retail	2,323.5
Apartment	1,074.9
Other - REITs / AFL-CIO Trust	233.2
Total Core Real Estate	\$8,949.1
Specialized Real Estate	
Natural Resources	\$782.9
Housing	670.2
California Urban Real Estate	211.3
Senior Housing	144.4
International	30.6
Opportunity Funds	0.4
Specialized Securities	771.4
Other - Technology	197.6
Total Specialized Real Estate	\$2,808.8
Total Real Estate	\$11,757.9¹

NOTE:

¹ Differences between investment values above and the values on the Summary of Investments on page 73 of the CAFR are due to differences in reporting methods.

The strong performance of our housing portfolio has made it the single highest returning investment program in the past 10 years, earning CalPERS and our members more than \$500 million since the program's start a decade ago.

The CalPERS Single Family Housing Program, which celebrated its 10th anniversary during the year, has earned more than 20 percent annually over the past decade, while also building 32,000 homes in California and across the nation. We invested \$375 million in residential development in the midst of California's recessionary cycle in 1992 to supplement the financing shortage for California builders. In the early 1990s California's population continued to grow, while building permits and funding for construction from the bank and savings and loan industry dropped significantly.

CalPERS has built nearly 200 California communities, with an average of 88 houses per project. More than 75 percent of homes constructed target first- and second-time homebuyers. Our initial investment has grown to more than \$1.5 billion and we have retained all our original real estate partners, including Hearthstone, Institutional Housing Partners, M/W Housing, Newland Capital Advisors, Resmark Equity Partners (formerly Olympic Realty Advisors, Residential Real Estate Partners, and Wells Fargo Realty Advisors. Each partner co-invests 10 percent of their own capital alongside CalPERS, preserving strong alignment of both our interests. Today, our housing program remains strong with excellent returns.

We continued to re-energize the California economy by investing an additional \$280 million in California urban real estate investments and adding four new affordable housing investment partners. The additional capital was earmarked for the CIM California Urban Real Estate Fund to support redevelopment efforts in Brea, Los Angeles, Sacramento, San Jose, and West Hollywood. We recognized that changing demographics and lifestyle preferences are increasing the demands for attractive urban locations, and are expected to produce strong returns for our portfolio.

Expansion, as well as downsizing, other parts of our portfolio also occurred during the year. In the opportunistic sector, we added two international funds and one domestic fund totaling \$225 million and sold our franchise finance portfolio for \$166 million. We locked in profits earned by our timber investments by selling off more than half of our \$1 billion allocation, and the Board gave our partners the ability to invest in real estate assets outside the United States, in Canada and Mexico.

The year was also marked with some notable acquisitions. We purchased Sunrise Assisted Living facilities in California, North Carolina, Pennsylvania, and Illinois. We bought more than 200 acres of vineyards in Sonoma County, California and Polk County, Oregon. We added 2.6 million square feet of industrial space to our portfolio when we purchased a national distribution portfolio of properties that is 100 percent leased to the Home Depot.

While the economic recession has caused the real estate market to soften in the short run, we expect that our real estate portfolio will continue to perform well. The recession has created investment opportunity, and we expect to place our focus on putting unallocated capital to work over the next year.

Global Equity

We maintained our investment focus in what continued to be a rough period for global equity markets.

During the 1980s and 1990s, equity returns were above average around the globe. Investors witnessed the Standard & Poor's (S&P) compound at 18 percent a year. The past three years have been a stark contrast as the S&P 500 has declined to 14 percent. Earnings weakness and corporate malfeasance have exacerbated the effects of a global recession, leading to higher risk premiums and increased volatility for investors.

A Closer Look at Global Public Markets

(Dollars in Billions)

	<i>Domestic</i>	<i>International</i>	<i>Total</i>
Fixed Income	\$32.9	\$5.0	\$37.9
Equities	58.5	27.6	86.1
Total Global Public Markets	\$91.4	\$32.6	\$124.0

Despite the market environment, we celebrated several accomplishments. The investment phase of our successful Manager Development Program began to come to a close during the year. We have allocated \$1.7 billion to 11 small and emerging money managers, and we expect that the next four years of the program will focus on future growth and development of these managers.

We also launched an Internal Relational Program in our Corporate Governance Unit. We purchased an equity ordering system designed to make our trades more efficient, and improve our investment monitoring and early problem identification and resolution. And we approved an expansion of our Absolute Returns Strategies Program to include a pool of strategic advisors, and purchased a system for sound fund accounting, compliance, and risk monitoring of the program.

The year marked a successful transition of our emerging market assets in accordance with our Board's permissible emerging equity market policy, including some refinements to the policy. The policy is believed to be the first of its kind ever done by a public pension fund. It looks beyond traditional economic factors and considers basic democratic principles when reviewing emerging markets for potential investment.

In an effort to avoid unnecessary transaction costs and prevent the System from continually moving in and out of emerging markets,

International Equity & Fixed Income Investments

Country Diversification

Up to \$25 million

Argentina Cayman Islands Czech Republic Peru

\$25 to \$50 million

Philippines Poland

\$50 to \$100 million

Chile Luxembourg Portugal
Hungary New Zealand

\$100 to \$300 million

Austria Ireland Singapore
Brazil Israel South Africa
Greece Norway Turkey

\$300 to \$500 million

Belgium Denmark Mexico Taiwan

\$500 million to \$1 billion

Hong Kong Finland Korea Sweden

More than \$1 billion

Australia Germany Netherlands United Kingdom
Canada Italy Spain
France Japan Switzerland

our Board adopted a year-long grace period for markets that fall off our permissible list. Called the “cure period,” emerging equity markets have one full year to improve before we take any action to liquidate our investments. Our hope is that the change sends a message to all countries that our door remains open to markets willing to work with us to achieve higher standards of market efficiency and transparency.

While we remain confident in the future of the global equity markets, we also remain realistic about return projections. We anticipate that returns will be in the single digits for the foreseeable future.

Global Fixed Income

Our global fixed income portfolio was the strong horse of our investment portfolio during the year, generating unmatched performance. Rebounding credit markets and excellent security selection by our Investment staff helped to deliver double-digit returns. Our global fixed income portfolio beat its benchmark, adding more than \$500 million in extra value to our Fund.

Success could also be found in our Securities Lending Program. Established in November 2000, the program runs on a Web-based platform that brings together lenders, borrowers, and brokers across the world. It enables institutional lenders like CalPERS to retain a larger share of the revenues associated with the lending process, by removing the agents, such as large custodian banks, who have

historically served as middlemen in securities lending and taking a negotiated cut from the income generated by the lending process. With this system in place, we were able to capture an additional \$80 million in value for our investment portfolio.

Corporate Governance

Restoring investor confidence and reforming the U.S. market continued to be our top priority. Institutional investors banded together to route out corporate fraud and greed, embarking on a number of financial market reform initiatives.

We launched a “Come Home to America” campaign urging American corporations like Tyco, Ingersoll-Rand, McDermott, Nabors Industries, and Cooper Industries who operate from the U.S., but have established mailing addresses in offshore havens, to reincorporate back to the U.S.

Our goal was to protect our shareholder rights, our investments, and the company’s bottom line. Offshore incorporations made it difficult to hold officers and directors accountable and to sue officers and directors for corporate waste and illegal conduct. Several states, including California have passed laws banning government agencies from contracting with expatriate American companies.

Our voices of concern were accompanied by full-page advertisements in the *Wall Street Journal* and the *USA Today*, asking companies to

come home to America. We urged other investors to support shareholder proposals on the issue. Our efforts gained momentum each month as labor unions, State Treasurers, and other officials joined in the campaign.

In the end, we viewed the outcome as a clear victory for shareowners. Tyco and a number of other companies placed the decision to move back under serious study over the next few years. What was once a resounding “no” response from companies, soon became a consideration.

We kept the pressure on other companies in our investment portfolio as well. We released our focus list of companies that represent some of the worst examples of poor financial and governance performance. This year’s list included Xerox of Stamford, Connecticut; Gemstar-TV Guide International, Inc. of Pasadena, California; JDS Uniphase Corporation of San Jose, California; Manugistics Group, Inc. of Rockville, Maryland; Midway Games, Inc. of Chicago, Illinois; and Parametric Technology of Needham, Massachusetts.

CalPERS pushed a variety of corporate governance improvements at these companies in an effort to generate better returns and long-term performance. Several companies agreed to corporate governance changes, including making their key committees completely independent, and providing for annual self-assessments of Board and committee performance.

During the year, we began to play a greater role in stewarding good corporate governance principles to European and Japanese markets. We invested \$500 million in three funds that employ corporate governance activism to turn around underperforming publicly-traded companies in Japan and Continental Europe. The Taiyo Fund, Sparx Asset Management, and the Hermes European Focus Fund make significant investments in a small number of publicly-traded companies, and use their influence as an active investor to effect corporate governance, financial, and operational change to benefit shareowners. Our experience indicates that active corporate governance strategies have proven successful and add value to our investment portfolio, and we expect that shareowners will play a greater role in the Japanese and European markets.

The Role of California Investments

CalPERS investments are a critical part of the economic fabric of California. Our record of investing in California extends back to the early 1980s, with investments in real estate mortgages and real estate equity. As of June 30, 2003, approximately \$17.2 billion was invested or committed for investment in California.

California investments are part of each asset class in our investment portfolio and are expected to deliver a return commensurate with similar investments of comparable risk. Our Board considers California investments—and all other investments as well—on the sole basis of investment merit. Investments must be financially

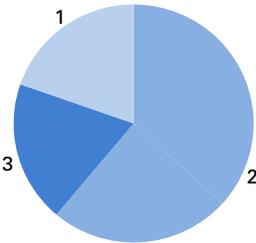
comparable to other available investment alternatives. The CalPERS Board judges comparability on a risk-adjusted basis. Under existing policy, we will accept no less in return, and may incur no additional risk or cost, for a California-oriented investment.

Investments in California may have the ancillary benefit of creating jobs, housing, and improvements to the State’s general infrastructure, and more importantly, serve the broad interests of CalPERS members. By strengthening the State’s economy and the well being of our employers, California investments help promote the continued ability of employers to make contributions to the System.

CalPERS California Investments & Commitments

at Market Value
\$17.2 Billion
(Dollars in Billions)

- 1. Real Estate Mortgages - **\$5.5**
- 2. Equities - **\$9.1**
- 3. Fixed Income - **\$2.6**



During the year, we added to our California investment portfolio by purchasing a number of high-quality assets. Country Club Plaza, a 369,000 square foot regional mall in Sacramento, California, became part of our retail portfolio. We purchased Ardenwood Corporate Park, a unique technology property in Fremont, California, near the heart of the Silicon Valley. We spent \$15.1 million on 7500 Tyrone Avenue, an urban infill industrial redevelopment project in California's San Fernando Valley. We also acquired Ivy Hill Apartments, a 116-unit property in Walnut Creek, California, and The Premiere at City Place Apartments, a multi-family development of 221 luxury units in Long Beach, California.

Today, we invest nearly \$9.1 billion in companies that make their home in California. These include established publicly-traded corporations and young entrepreneurial businesses that rely on CalPERS private placement capital for growth and expansion. Our fixed income assets, largely held in mortgage pass-throughs total approximately \$2.6 million. We have earmarked more than \$1 billion for real estate development and redevelopment in urban areas of California. And our Member Home Loan Program, implemented in 1989, has made more than 108,000 real estate loans, totaling more than \$16.3 billion.

CalPERS no longer produces a separate Annual Investment Report. All the information previously included in that separate volume is now contained in this Operations Summary and the accompanying Comprehensive Annual Financial Report. A complete listing of all portfolio holdings is available on the CalPERS Web site at www.calpers.ca.gov.



Legislative Update

State Legislative Update

This past year, the CalPERS Board worked diligently with staff to develop legislative positions and proposals that served the best interest of our members and employers. Through our collaborative efforts with interested stakeholders, we supported or sponsored legislation that provided improvements to our benefits or enhanced program design. The Board uses its own Legislative Policy Standards as a guide in formulating positions.

The following is a brief summary of some of the CalPERS-related legislation enacted during the first year of the 2003-04 Session of the California Legislature. (New laws become effective January 1, 2004 unless otherwise noted.)

A.B. 205, Chapter 421 (Goldberg)

Enacts the California Domestic Partner Rights and Responsibilities Act of 2003, which extends the rights and duties of marriage to those registered as domestic partners on or after January 1, 2005. Grants domestic partners the same rights and duties as a spouse with regard to all State laws, including community property, pension and death benefits, taxes, and health insurance coverage. Does not modify eligibility for the CalPERS Long-Term Care Program.

A.B. 475, Chapter 97 (Correa)

Gives the CalPERS Board the authority to increase the maximum for a Member Home Loan Program loan from the present limit of 95 percent of value to 100 percent.

A.B. 719, Chapter 838 (Negrete McLeod)

Authorizes CalPERS members to purchase from one to five years of “unqualified” service credit. Members must have five years of CalPERS service to be eligible to purchase unqualified service.

A.B. 1606, Chapter 271 (Shirley Horton)

Allows an employee of a contracting public agency and their family members to continue enrollment in the CalPERS Health Program, for up to one year, if their employer grants them a military duty leave. (Urgency measure, effective September 4, 2003.)

S.B. 268, Chapter 856 (Soto)

Allows certain members who purchase service credit on installment payments (or their survivors) to prospectively discontinue payments if they become disabled or die under special death circumstances, and the additional service credit will not benefit them or their survivors. Also, provides a new retirement calculation for a member whose retirement account has been separated due to a community property settlement. Allows a divorced member to exercise certain rights when the “nonmember” spouse forfeits those rights by electing a refund of contributions.

S.B. 269, Chapter 856 (Soto)

Authorizes the CalPERS Board to determine the compensation of certain key positions. These determinations must be guided by the principles contained in statutes governing the creation of salary ranges for each class or position. The bill also contains a similar provision to allow the California State Teachers' Retirement System's Board to determine the compensation of certain key positions.

S.B. 436, Chapter 751 (Soto)

Allows the Board to establish criteria for public agencies participating in the CalPERS Health Program through the regulation process. Also allows the Board to develop longer-term contracts with health plans, and to offer regionally-priced health plan premiums for public agency employees and retirees. In addition, the Board can offer health plans exclusively for the employees and retirees of contracting agencies.

Federal Update

Our federal relations program continued to ensure that the interests of the System, our members, and our employers were addressed in the overall federal policymaking process during the 2002-03 fiscal year.

Although the top focus of Congress and the White House was the military conflict in Iraq, key legislation of critical importance to CalPERS retirement, health benefits, and investment programs was also addressed.

CalPERS Board President Sean Harrigan testified before Congress and presented the System's views on executive compensation and corporate accountability, building on CalPERS involvement in 2003 legislation on corporate bankruptcies. At the same time, CalPERS took center stage on other corporate responsibility issues, including a proposal by the Securities and Exchange Commission to allow greater shareholder input in board director elections and plans to revamp the New York Stock Exchange after its compensation scandal.

CalPERS federal representatives developed a federal health care action plan designed to give CalPERS a greater voice in Washington, D.C. Strategies contained in the plan will increase our influence in the national arena and push the political debate in the direction of reining in health care costs and reducing the number of uninsured Americans. The new plan advances six broad-based goals to position the health care crisis at the top of the priority lists of key decision-makers at the dawn of the next Presidential administration and the start of the 109th Congress in 2005.

And, with CalPERS backing, California Congressman Pete Stark sponsored a bill to limit business tax deductions for direct-to-consumer advertisements for prescription drugs that are not presented in a fair and balanced manner.

Legislation is pending in Congress that would make improvements to public sector pension plans. The bill resolves concerns over the

effect of proposed rules on minimum distributions from defined benefit plans that would have had an adverse impact on many State and local government laws, regarding such things as cost-of-living allowances and alternative forms of benefit payments. In addition, it would enhance the ability of public employees to purchase service credit in their defined benefit plans in order to build for their retirement security. The measure would also lower the separation from service exception to age 50 for public safety workers so they could avoid the 10 percent penalty tax on early distributions.

Congress also considered legislation to make changes to the Government Pension Offset (GPO) program that would close the GPO last-day loophole. This legislation would allow certain workers with jobs outside Social Security coverage to avoid the offset. It would also increase enforcement of GPO and the windfall elimination provision by requiring information reporting to the IRS on pension benefits that are based on work covered by Social Security.

Social Security is expected to be a top priority in Washington, D.C. next year, and while support for mandatory Social Security coverage of all newly-hired State and local government employees has been successfully stalled, it could resurface. CalPERS, in collaboration with a coalition of public sector groups, has led the effort to prevent mandatory coverage.



The Year Ahead

This Operations Summary has highlighted many of our accomplishments during the fiscal year. CalPERS has achieved a great deal, but we must now be prepared and poised for the future.

In some ways, it has been a real sprint toward improvement. However, no organization, not even one as strong as CalPERS, can sustain that pace year in and year out. As we look ahead, we must prepare to engage in a steadier and sustainable pace of improvement.

In moving forward, several themes will guide our work: creating long-lasting solutions, restoring robustness to our investment rate of return, implementing our strategic plan for health care, and continuing to harness technology to make us more efficient and customer service oriented.

In the next year, we'll continue improvements in our Customer Contact Center, bringing on enhanced services for accessibility, availability, and responsiveness to members and employers. Our goal is to increase the number of member and employer telephone calls answered on their first attempt. We are currently closing nearly 90 percent of all calls at the initial point of contact and answering 90 to 94 percent on the first attempt.

Continuing with our customer services improvements, we hope to achieve increased operational efficiencies and effectiveness and see measurable reductions in our transaction costs in processing member retirement applications, service credit requests, customer correspondence, and beneficiary designations.

We also plan to continue providing educational workshops and seminars throughout the State and our retirement counseling services; however, we'll be focusing on ways to provide services that are relevant to members' career life cycles. We will also explore different communication channels to reach more members earlier in their working careers.

As our membership continues to increase and our members are living longer, preparing for the "baby boomer" retirements is an issue we will need to address. As this trend gains momentum, we recognize that we must rise to the challenge and respond to the changes taking place in our demographics by continuing to build our organizational infrastructure to prepare for the additional demands on our workforce. We will look into developing a strategy to address these concerns as we work harder than ever to manage in tough fiscal times and meet the needs of all our members.

All good organizations plan for the future and CalPERS is no exception. We are committed to the growth of our staff and we will continue to provide a myriad of learning opportunities. During the course of

next year, we'll be taking a more proactive role in developing tomorrow's managers today through training programs designed to address career path opportunities and job choices. We will also develop a formal succession plan to ensure that our programs will have continuity as our leadership continues to evolve.

Another primary focus will be working further on our risk pooling approach to help our smaller employers by reducing the fluctuations in their rates while maintaining benefit flexibility. We will seek to implement a process that will minimize the impact of adverse demographic experience on their contribution rates. We will continue to work with our employers facing increasing contribution rates to dampen the impact of investment losses on their rates.

In the health care arena, we'll begin executing elements of our Strategic Plan for Health focusing on delivering better value from plans, hospitals, physicians, and prescription drug providers. It includes incentives for doctors and hospitals to have at least three care management programs for high-risk individuals and five chronic disease management programs.

We will join with other large health care purchasers to share information and collaborate in efforts to gain more negotiating power in the marketplace. We will begin to phase in multi-year contracts with our HMOs to help reduce costs. This is key path for providing greater price stability and value with our strategic partners.

We will also work with our advisory groups, comprised of State and public agency constituents, to explore alternative health benefit designs to provide more options and flexibility in health benefits for our members and employers. We'll continue to be active and take a leadership role in State and federal health policy debates to secure fundamental reforms and to combat rising health care costs, here in California and the nation as a whole.

In our asset management area, we will continue to make improvements to our technology and business processes for the Fixed Income Trading System. We also plan to implement the Equity Order Management System, another technology improvement that will enhance the business process in our internal equities management.

Another focus will be enhancements to our Risk Measurement System in the area of credit, performance what-if, and value at risk. Our object is to achieve an enterprise-wide view of the investment and risk profile for the Fund, and to increase return on risk taken, and to establish an appropriately focused risk culture.

In the year ahead, we will remain aggressive in our corporate governance arena and continue to add value through active management of our investments. And, we'll manage our assets in a way that provides maximum advantage to our members and employers over the short and long term.

Return on investment will be the watchword for all of our projects. While CalPERS always looks for return on investment in our investment affairs, a greater focus will also be applied to other programs. We will get the most value out of the programs we offer.

We'll continue to improve and refine member transactions to be simpler, quicker, and more effective. Expanding the reach of our technology resources will increase operational efficiencies and provide better service, and we will work diligently to harness the power of our Web site for easy member and employer access.

As we look forward to the year ahead, we will remain committed and focused on our Strategic Plan. Our day-to-day work is critical to so many people's lives, our number one priority remains in providing retirement and health security to all those we serve.



CalPERS

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 Printed on recycled paper.