

Trusted Guide: **Members well prepared for a secure and rewarding future**

your voice;

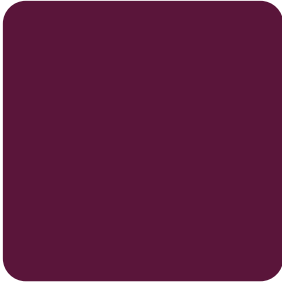
“I didn’t like that I had to use my Social Security number over the Internet to begin the e-mail process. I’m concerned about identity theft.”

our commitment

CalSTRS frequently uses only the last four digits of a member’s Social Security number and has begun using a unique member account number instead, a change that focus group members appreciated.



Investments



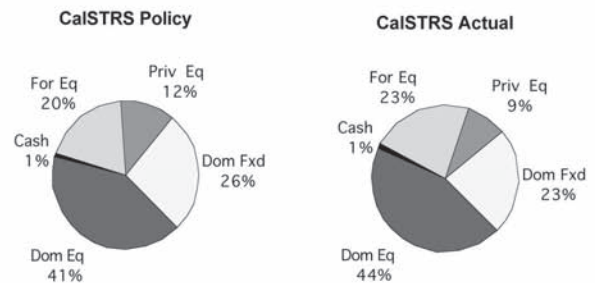
Investment Consultant's Report



The CalSTRS investment portfolio increased by \$15.6 billion over the past twelve months ending with a value of \$116.2 billion on June 30, 2004. As highlighted below, the CalSTRS portfolio is broadly diversified, holding investments ranging from publicly-traded short-term bonds to privately-held partnerships. Clearly, the scale and breadth of investments make the management and oversight of these assets highly complex. In light of these factors, CalSTRS has been effective in using its resources in a cost-efficient manner to ensure that benefits continue to flow to CalSTRS participants.

Investment Allocation

The most critical factor influencing overall investment performance is the allocation of the CalSTRS portfolio across major asset classes. The fiscal year-end report reflects asset allocation guidelines for the 2003-2004 fiscal year as a step towards long-term targets adopted in October of 2001 (see left pie chart). The portfolio's actual allocation is slightly different from policy. Domestic Equity and Foreign Equity are slightly over weighted while Private Equity and Domestic Fixed are underweighted (see right pie chart). Gains in the domestic public equity markets over recent periods contributed to the overweighting of the Domestic Equity asset class. In addition, the major asset classes may be strategically overweight versus their policy target(s) to compensate for the difficulty of rapidly funding the private equity asset class.

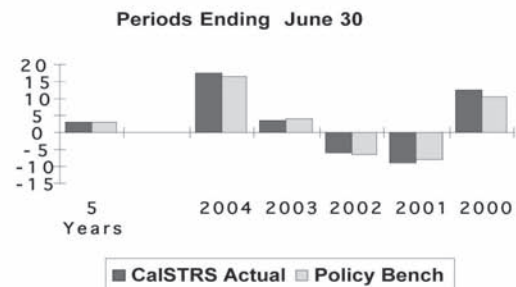


Investment Results

Over the last year, the CalSTRS investment portfolio produced a strong absolute return of 17.4% ranking in the top quartile among its large public pension fund peers¹ (top bar chart). During this period, portfolio results exceeded the policy benchmark return by 1.0%.² Relative outperformance by the Domestic Equity and Private Equity asset classes contributed significantly to this result.



During the last three years, CalSTRS' portfolio generated a 4.5% return outperforming the policy benchmark by 40 basis points and placing above median vs. their peer funds. Over the last five years, the CalSTRS investment portfolio produced an average annual return of 3.2%, exceeding its policy benchmark by 40 basis points per year (bottom chart). However, these results are significantly below CalSTRS' actuarial rate of return. Successive one-year periods are shown as well. CalSTRS' portfolio has outperformed its policy benchmark in three of the last five years for periods ending June 30.³



Pension Consulting Alliance, Inc.

¹ Per TUCS Universe for Public Funds with assets in excess of \$1 billion.

² The policy benchmark consists of passively managed asset class portfolios weighted by CalSTRS' policy allocations. The difference between actual results and the benchmark are due to two factors: i) deviations from policy and ii) active decisions on the part of CalSTRS and its investment managers.

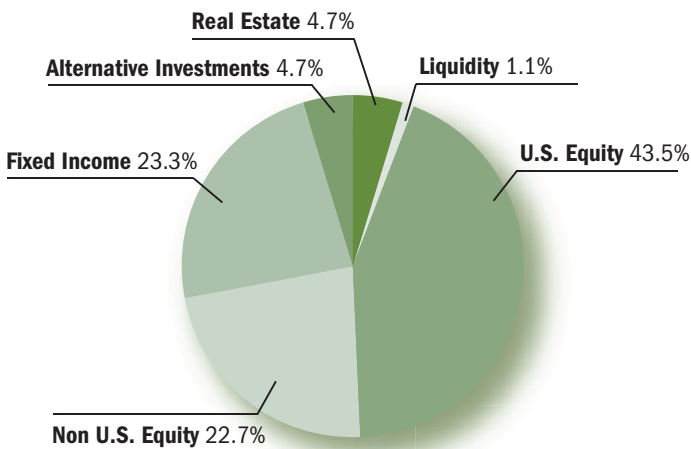
³ CalSTRS' investment performance is calculated using a monthly internal rate of return and day-weighted cash flows. Periods longer than one month are geometrically linked. This method of return calculation complies with AIMR performance presentation standards.

Investments

The CalSTRS investment portfolio has fully recovered from the 2000–02 bear market and internet/high tech bubble. In fiscal year 2003–04 the investment portfolio generated a spectacular 17.4 percent investment return and hit an all-time high of \$116 billion, exceeding the previous high set in mid-2000. Diversification and strategic rebalancing of the portfolio helped CalSTRS recover faster than most state pension plans and institutional investors.

Fiscal year 2003–04 saw an investment market divided into two distinct periods. The first half of the year, July to December 2003, the U.S. and Non-U.S. equity market climbed in value. However, during the second half of the year, the market traded sideways as uncertainty built. CalSTRS’ diversification across industry sectors and different types of investments produced a lower risk and higher return portfolio.

Asset Allocation as of June 30, 2004
Total investment portfolio of \$116.2 billion

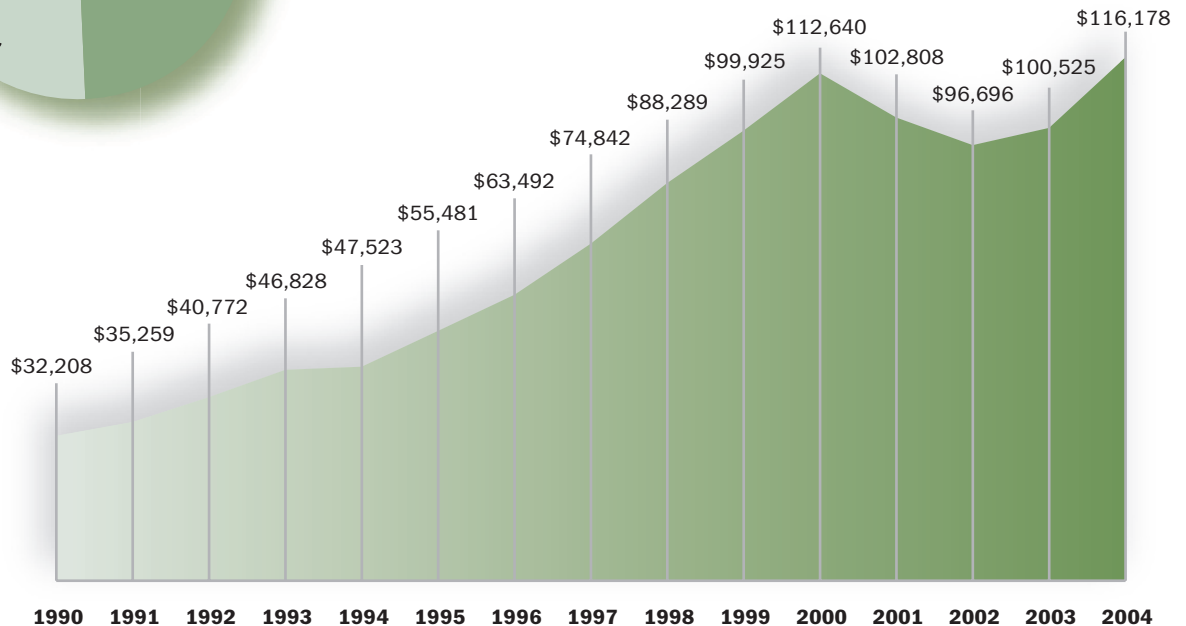


During the past year, the Teachers’ Retirement Board Investment Committee and CalSTRS staff revised several key policies to significantly increase the level of active management within the U.S. equity portfolio. This was accomplished by establishing two important new programs. The first program allocated \$800 million into corporate governance funds, which strive to improve the governance and efficiency of companies. The second program allocated \$600 million to newer, small U.S. equity managers. Three firms were hired to identify highly skilled developing money managers. This group will likely be very diverse and help provide CalSTRS with new money managers for the 21st century.

As the Investment Committee and staff look toward future years, it is highly likely that double-digit investment returns will be more difficult to achieve. Many economists and consultants forecast that the next ten years will exhibit very low single-digit returns. Our key objective is to earn more than an 8 percent return over a 10-year period. In the 1990’s this was very easy to accomplish. If the pundits are correct, this objective will be more difficult. This means CalSTRS members should lower their expectations for excess returns and enhanced benefits.

In the future year, the Investment Committee will be reviewing various portfolio enhancement ideas to add additional return potential without significantly increasing the portfolio’s total risk. With the full complement of Board members, top flight consulting and one of the best investment staffs in the country, the investment portfolio is in good hands.

Chart A Growth in total investments (dollars in millions)



Objectives

The core objectives of the Investment Management Plan remained unchanged. The primary objectives are set forth in the California Constitution and the California Education Code. The foremost objective is to provide for present and future benefit payments,

then to diversify the assets, and finally, to reduce CalSTRS funding costs. Additionally, the Teachers' Retirement Board and staff strive to run the investment program in such a manner so as to maintain the trust of the participants and public.

Chart B Growth in CalSTRS' returns (percent)

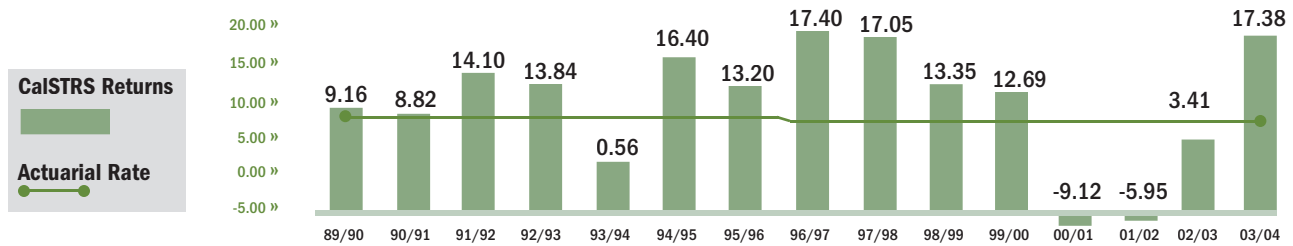


Chart C Time-weighted performance returns for major asset categories

Portfolio Type / Associated Indices	1 Yr	3 Yr	5 Yr	10 Yr
Total Fund	17.38	4.51	3.17	9.15
US Equity	20.96	0.61	-0.80	11.24
Russell 3000 *	20.48	-0.17	-1.38	11.49
Wilshire 5000	21.25	0.79	-1.03	11.54
Non-US Equity	30.68	4.48	0.86	5.11
MSCI All Country Free ex US (G) *	32.42	5.12	0.78	4.31
MSCI Europe, Australia & Far East *	32.31	3.74	-0.02	4.01
MSCI Emerging Market Free *	33.54	13.05	3.14	1.14
Fixed Income	0.67	7.32	7.48	8.36
US Debt Custom ⁽¹⁾	0.88	7.56	7.72	8.26
Salomon LPF	-0.79	7.48	7.67	8.24
Lehman Brothers US Aggregate	0.32	6.36	6.95	7.39
Lehman Brothers High Yield Cash Pay	10.09	9.08	5.28	7.60
Real Estate	13.20	10.18	10.69	12.02
Real Estate Custom ⁽²⁾	9.84	7.74	9.06	9.95
Alternative Investments	29.62	4.73	11.89	19.61
Alternative Investments Custom ⁽³⁾	17.24	6.68	7.41	10.85
Liquidity	19.01	8.42	7.70	6.81
Salomon 3-Month Treasury Bill	0.96	1.61	3.14	4.16

Investment performance is calculated using a time-weighted rate of return based on the market rate of return in accordance with Association for Investment Management and Research (AIMR) Standards

* CalSTRS adopted tobacco free indices beginning 9/1/00

⁽¹⁾ Blend of Salomon LPF, LB US Aggregate and LB High Yield Cash Pay for the year ending 6/30/03 due to benchmark transition

⁽²⁾ NCRIF after 7/1/97 and Institutional Property Consultants prior to 7/1/97; lagged 1 quarter

⁽³⁾ Blend of the [Russell 3000 + 5% + 90 day T-Bill] after 4/1/99 and [CPI + 12%] prior to 4/1/99; lagged 1 quarter

Chart D Largest fixed income holdings as of June 30, 2004 (CalSTRS maintains a complete list of portfolio holdings)

<i>Issue</i>	<i>Maturity Date</i>	<i>Interest Rate</i>	<i>Par</i>	<i>Market Value</i>	<i>Average Cost</i>	<i>Unrealized Gain/(Loss)</i>
US TREASURY BONDS	15-Nov-16	7.500%	445,000,000	548,547,037	552,914,955	(4,367,918)
US TREASURY BONDS	15-Nov-06	2.625%	550,000,000	546,210,484	553,772,402	(7,561,919)
US TREASURY BONDS	15-Oct-06	6.500%	325,000,000	350,882,964	356,452,137	(5,569,173)
US TREASURY BONDS	15-Jul-06	7.000%	300,000,000	325,032,027	328,393,537	(3,361,510)
US TREASURY BONDS	30-Apr-06	2.250%	325,000,000	322,754,244	323,985,612	(1,231,369)
US TREASURY BONDS	15-May-08	2.625%	290,000,000	280,978,100	281,093,805	(115,705)
FEDERAL NATL MORTGAGE ASSN	15-Jun-10	7.125%	240,000,000	272,572,798	287,140,110	(14,567,313)
US TREASURY BONDS	15-Sep-08	3.125%	260,000,000	255,184,808	259,902,155	(4,717,347)
US TREASURY BONDS	15-Feb-20	8.500%	175,000,000	236,817,009	225,257,643	11,559,366
FREDDIE MAC	15-May-07	2.875%	215,000,000	211,613,756	213,961,356	(2,347,600)

Fixed Income

The fixed income assets within the CalSTRS investment portfolio include \$24.9 billion of internally managed investment grade securities and \$2.2 billion of externally managed high yield securities, which collectively are expected to generate a risk-adjusted return that is representative of the broad market-weighted universe of U.S. bonds. The strategic performance objective for the Teachers' Retirement Fund's fixed income portfolios is to enhance the value of the total investment portfolio by exceeding the total return of the performance benchmark by up to 25 basis points annually over a full market cycle. For the fiscal year ended June 30, 2004, the fixed income portfolios earned 0.67 percent, trailing the performance benchmark by 21 basis points.

Three other programs are managed within the Fixed Income Unit: Currency Hedging, Home Loan and Securities Lending.

Currency Hedging Program

The Currency Hedging Program protects the value of the assets of the passively managed segment of the non-dollar equity portfolio by selling controlled amounts of foreign currency positions in approved currencies (i.e., hedging) when there is the risk that the U.S. dollar may strengthen and removing them when there is widespread U.S. dollar weakness. A strengthening dollar lowers international equity returns. Over the past year, the U.S. dollar has trended lower against its major trading partners. Therefore, in order to receive maximum potential benefit in relation to its unhedged benchmark, all core currency hedges were removed. Through the fiscal year ended June 30, 2004, the Currency Hedging Program has generated nearly \$600 million in additional income, offsetting a corresponding decline in the non-dollar equity portfolio.

Home Loan Program

The CalSTRS Home Loan Program, established by legislation in 1984, provides the opportunity for home ownership to qualified participants while meeting CalSTRS' investment goals by generating a mortgage

asset. The Home Loan Program strives to offer borrowers a variety of mortgage programs that best meet their individual needs, while also providing "best in class" customer service to our borrowers—before, during, and after the mortgage loan process. The assets created by the Home Loan Program are purchased and managed as part of the mortgage allocation within the Fixed Income Portfolio, or sold in the financial markets. As a result, the Home Loan Program is held to the same investment standard and compared to the same performance benchmark as the other mortgage related assets within the Fixed Income Portfolio. This year, CalSTRS added Countrywide Home Loans to its team of strategic partners to bring operational and technological improvements to the Home Loan Program, thereby ultimately enhancing the quality of service to our borrowers.

Securities Lending Program

The Securities Lending Program was designed to enable the Fund to generate incremental income by making collateralized, low-risk, short-term loans, using a portion of the equity and fixed income assets held within the investment portfolio. The performance objective for the program is to earn lending income commensurate with: 1) the market demand for the securities made available for lending and, 2) the return earned on the investment of cash collateral within the guidelines set forth by CalSTRS. For the fiscal year ended June 30, 2004, the Securities Lending Program earned approximately \$69 million in additional income for the Fund.

Internal Equity Management

The Internal Equities group was established to manage a portion of CalSTRS' domestic equity allocation. This is accomplished with two portfolios, a passively managed index fund and a cash equitization program. The index portfolio is benchmarked to the Russell 1000 ex-Tobacco Index and was valued at \$17.4 billion as of June 30, 2004. The portfolio had a return of 19.57 percent during the 2003-04 fiscal

year, which outperformed the benchmark return of 19.49 percent by 0.08 percent. The indexed portfolio's annualized two-year return ending June 30, 2004 was 9.89 percent against the benchmark's return of 9.79 percent, outpacing the benchmark by 0.10 percent.

The cash equitization program pools the excess cash in CalSTRS' actively managed domestic accounts so that these monies can be invested and gain exposure to the equity market. This portfolio is benchmarked to the S&P 500 Index and assures tighter tracking of the overall U.S. equity segment to its benchmark. As of June 30, 2004, the portfolio was valued at \$223.1 million. The one-year return for the portfolio ending June 30, 2004 was 19.48 percent while the benchmark lagged at 19.11 percent, a difference of 0.37 percent. The three-year annualized return was 0.45 percent with the benchmark at -0.69 percent. The cash equitization program outperformed the benchmark by 1.14 percent.

Alternative Investments

The Alternative Investments asset class invests in the private equity universe. These investments involve companies that are not publicly traded and normally require active involvement by the external equity managers hired by CalSTRS. The vast majority of these investments are made through limited partnership portfolios, which consist of pools of investments.

During fiscal year 2003–04, CalSTRS made additional commitments of approximately \$1.7 billion in this segment of the portfolio. Total commitments now amount to approximately \$9.18 billion. There are 135 partnerships and 13 co-investments in the Alternative Investment portfolio. At the end of the fiscal year, the total market value was \$5.4 billion, representing approximately 5.0 percent of the total CalSTRS portfolio. CalSTRS continues to increase its commitments in this area as a result of the allocation review completed in October

2001. The Alternative Investment asset class has achieved annualized returns of 29.6, 4.73 and 11.89 percent, for the 1-, 3-, and 5-year periods respectively, lagged one quarter.

Credit Enhancement

CalSTRS has long-term credit ratings of AA+/AA+/AAA by Standard and Poor's, Moody's Investors Service, and Fitch Inc., respectively. The ratings are utilized by issuers of municipal debt in California to assist in the issuance of variable rate municipal bonds. CalSTRS enters into agreements with a number of issuers of tax-exempt debt to provide the payment of principal and interest in the event of a non-payment and/or market support in the capital markets. In return, CalSTRS earns fee income for these commitments. Most of the transactions are supported by banks or bond insurers for repayment. As of June 30, 2004, the Credit Enhancement Program had commitments of approximately \$1.6 billion and fee income earned during the fiscal year was approximately \$6 million.

Real Estate

CalSTRS portfolio of leveraged real estate assets is valued at \$5.4 billion. The real estate portfolio is comprised of 114 directly owned properties, 9 joint venture relationships, and investments in 20 opportunity funds. During the last fiscal year, ten assets were acquired (either fully owned by CalSTRS or with a joint venture partner), and 17 assets were sold. Real estate assets are 4.7 percent of the total fund with a 6.0 percent allocation. The direct property portfolio is diversified as to property type and geographic location. The largest component of the direct property sector is office buildings, with the largest weighting in the western region of the United States. During fiscal year 2002-03 a Leverage Program was implemented. Two debt strategies were executed: a \$750 million Commercial Mortgage Backed Security (CMBS) transaction and a \$275

Chart E Largest equity holdings as of June 30, 2004 (CalSTRS maintains a complete list of portfolio holdings)

<i>Issue</i>	<i>Shares</i>	<i>Market Value</i>	<i>Average Cost</i>	<i>Unrealized Gain/(Loss)</i>
General Electric Co	37,736,468	\$1,222,661,563	663,610,455	\$559,051,108
Exxon Mobil Corp	24,935,294	1,107,376,407	597,055,643	510,320,763
Microsoft Corp	36,253,209	1,035,391,649	596,363,590	439,028,059
Pfizer Inc	29,357,909	1,006,389,121	597,438,915	408,950,205
Citigroup Inc	20,846,699	969,371,504	483,760,098	485,611,405
Intel Corp	25,529,117	704,603,629	335,282,370	369,321,259
Bank of America Corp	8,075,364	683,337,302	343,794,668	339,542,633
Johnson & Johnson	11,925,538	664,252,467	390,892,123	273,360,344
American International Group Inc	9,204,405	656,089,988	313,676,649	342,413,340
Cisco Systems Inc	27,368,032	648,622,358	384,428,869	264,193,490

million net revolving line of credit. The CalSTRS' real estate portfolio has achieved gross annualized returns of 13.2, 10.1 and 10.7 percent for the 1-, 3- and 5-year periods, respectively. CalSTRS' return exceeded the NCREIF benchmark by 3.5, 2.4 and 1.4 percent for each of the 1-, 3- and 5-year periods.

External Equity Management

The Public Equity portfolio, comprised of both internally and externally managed portfolios, continued to be an important investment vehicle to the fund. In fiscal year 2003-04, this segment of the portfolio accounted for about 66.2 percent (or \$76.9 billion) of the total fund. Domestic Equity accounted for 43.5 percent of the total equity allocation, while International Equity accounted for the remaining 22.7 percent.

The External Equity portfolio is managed by 17 external domestic managers and 17 external international managers. The equity markets stabilized in fiscal year 2003-04 compared to 2002-03. CalSTRS domestic active managers outperformed their benchmark (Russell 3000 x Tobacco Index) by 206 basis points (22.54 percent vs. 20.48 percent); however, the international active managers underperformed their benchmark (MSCI EAFE x Tobacco Index) by 335 basis points (28.76 percent vs. 32.31 percent).

External Domestic Equity Programs

During the 2003-04 fiscal year, CalSTRS established two domestic equity programs. Both of these programs are in the very early stages of implementation. The total target allocation is \$1.4 billion.

- The first program targets developing managers with less than \$2 billion under management. CalSTRS retained three firms under a manager of manager structure. These firms are charged with hiring investment managers with different styles and capitalization with the overall benchmark being the Russell 3000.
- The second program takes into account relational investments. Two firms were retained to manage portfolios with corporate governance as its main theme.

Corporate Governance

During the 2003-04 fiscal year, CalSTRS voted on a variety of proxy issues including financial, corporate governance and social issues. More than 7,900 votes were cast on proxy issues of corporations whose shares were owned in the investment portfolio. These proxy issues were presented on approximately 2,973 companies. The overall number of proxy issues increased from 6,909 last year.

The major issues voted are summarized below:

1. Election of Directors: CalSTRS generally votes in favor of directors unless the proxy statement shows circumstances contrary to policy. Examples of such circumstances are: greater than 50 percent board representation by company executives, potential conflict of interest due to other directorships or employment, and classification of the company directors.

Number Voted: 2,785

For: 2,333

Against: 452

2. Selection of Auditors/Accountants: CalSTRS reviews votes for the independent auditors and accountants on a case-by-case basis.

Number Voted: 1,859

For: 663

Against: 1,196

3. Compensation Plans: (Stock Options, Incentive Stock Options, Employee Stock Purchase Plans, etc.) Corporations provide a variety of compensation plans to keep executives, employees and non-employee directors. A number of these plans provide for the issuance of long-term incentives to attract, reward and retain key employees. Compensation plans are evaluated based on CalSTRS Financial Responsibility Criteria.

Number Voted: 893

For: 299

Against: 594

4. Approve Merger/Acquisition-Management: CalSTRS generally votes in favor of the acquisition or merger of one company into another.

Number Voted: 188

For: 180

Against: 8

5. Corporate Actions/Corporate Governance Issues: These are issues related to spin-offs, stock splits and incorporation. CalSTRS votes these proposals on a case-by-case basis.

Number Voted: 36

For: 28

Against: 8

6. Other-Miscellaneous-Management: Miscellaneous business recommended by management is decided on a case-by-case basis.

Number Voted: 496

For: 223

Against: 273

Cash Balance Benefit Program

The Cash Balance Benefit Program contributions were invested into pooled funds from inception (February 1, 1997) through June 30, 2001. Sixty percent of the contributions were allocated to the S&P 500 portfolio and 40 percent to the Government Index portfolio. Beginning July 1, 2002, Cash Balance Benefit Program contributions are invested in the Teachers' Retirement Fund Excluding Private Equity (Alternative and Real Estate investments). For the fiscal year ending June 30, 2004, the investment value of contributions, was \$42.0 million and the rate of return was 17.0 percent.

Defined Benefit Supplement Program

The Defined Benefit Supplement Program contributions are invested in the Teachers' Retirement Fund Excluding Private Equity (Alternative and Real Estate investments). Contributions were first received in the Defined Benefit Supplement Program in January 2001. The investment value of those contributions, as of June 30, 2004, is \$2.0 billion. Since the inception of the Defined Benefit Supplement Program, the annualized rate of return is 2.0 percent. The rate of return for the Defined Benefit Supplement Program for the fiscal year is 17.0 percent.

Chart F Investment summary for the current and previous fiscal year (dollars in millions)

Portfolio Type	30-Jun-03		30-Jun-04			
	Book Value	Market Value	Book Value	Market Value	% of Market Value	Net Market Change
US Equity	\$31,106	\$41,140	\$33,780	\$50,523	43.49%	\$9,383
Non-US Equity	21,354	20,171	22,697	26,427	22.74	6,256
Fixed Income	25,528	26,939	27,020	27,113	23.34	174
Alternative Investments	5,034	5,072	5,057	5,437	4.68	365
Real Estate	4,779	4,579	5,338	5,436	4.68	759
Liquidity	2,624	2,624	1,242	1,242	1.07	-1,382
Total Portfolio	\$90,426	\$100,525	\$95,133	\$116,178	100.00%	\$15,555
Plus: Securities Lending Collateral		14,367		17,011		
Less: Accruals		-819		-1,365		
Less: Cash & Cash Equivalent		156		181		
Plan Net Assets-Investments		\$115,555		\$134,373		

Chart G Schedule of investment expenses from continuous appropriation from July 1, 2003, through June 30, 2004 (dollars in thousands)

	Assets Under Management	Fees	Basis Points
Investment Managers' Fees:			
US Equity	\$32,490,693	\$20,884	6.4
Non-US Equity	26,426,697	32,349	12.2
Fixed Income	2,168,591	4,593	21.2
Alternative Investments	5,437,445	2,282	4.2
Real Estate	5,435,805	15,501	28.5
Total Investment Managers' Fees	\$71,959,230	\$75,608	10.5



This is personal...

your voice;

“This is an extremely personal subject, and you want the ones you are dealing with (CalSTRS) to feel the same way.”

our commitment

When a death occurs, one caseworker is assigned to each family until all benefits are paid. There is no application needed since the caseworker does an initial interview via telephone to explain the process and gather the necessary information.

Chart H Broker commissions July 1, 2003, through June 30, 2004

Broker Name	Commission	Shares	Commission per Share
US Equity Transactions			
BNY Brokerage Inc	\$760,693	19,585,650	\$0.039
CitigroupGlobal Markets Inc	676,445	22,770,875	0.030
Merrill Lynch Pierce Fenner & Smith Inc	669,532	21,833,026	0.031
Instinet	573,947	24,779,347	0.023
Morgan Stanley & Co Inc	502,609	21,487,632	0.023
Investment Technology Group Inc	498,622	22,367,849	0.022
Jefferies & Co	480,844	16,010,604	0.030
Lehman Bros Inc	468,778	14,659,101	0.032
Lynch Jones & Ryan	442,740	8,910,407	0.050
CS First Boston Corp	431,511	14,511,794	0.030
Other US Brokers	9,088,509	247,034,066	0.037
Total Commissions on US Equity Transactions	\$14,594,230	433,950,351	\$0.034
Non-US Equity Transactions			
Merrill Lynch	\$2,933,762	1,124,762,253	\$0.003
Credit Suisse Bank	1,513,333	159,459,578	0.009
Goldman Sachs	1,267,441	166,242,398	0.008
Citicorp Securities Markets Inc	1,186,868	174,171,419	0.007
Morgan Stanley & Co	1,169,695	81,088,811	0.014
J.P. Morgan Securities LTD	1,108,099	223,730,525	0.005
Deutsche Bank Securities Corp	1,061,123	1,257,829,816	0.001
UBS Ag	1,032,782	296,157,134	0.003
Lehman Brothers Securities	1,003,479	89,924,635	0.011
Warburg Securities	824,513	128,224,648	0.006
Other Non-US Brokers	6,801,825	11,257,210,074	0.001
Total Commissions on Non-US Equity Transactions	\$19,902,920	14,958,801,291	\$0.001