



STATE OF NEW JERSEY
NEW JERSEY STATE EMPLOYEES DEFERRED COMPENSATION PLAN

Financial Statements

June 30, 2006 and 2005

(With Independent Auditors' Report Thereon)



KPMG LLP
Suite 402
301 Carnegie Center
Princeton, NJ 08540-6227

Independent Auditors' Report

New Jersey State Employees Deferred
Compensation Plan Board
New Jersey State Employees Deferred
Compensation Plan:

We have audited the accompanying statements of fiduciary net assets of the State of New Jersey Employees Deferred Compensation Plan (the Plan) as of June 30, 2006 and 2005, and the related statements of changes in fiduciary net assets for the years then ended. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the New Jersey State Employees Deferred Compensation Plan as of June 30, 2006 and 2005, and the changes in its financial position for the years then ended in conformity with U.S. generally accepted accounting principles.

Management's Discussion and Analysis is not a required part of the basic financial statements but is supplementary information required by U.S. generally accepted accounting principles. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

KPMG LLP

January 25, 2007

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Management's Discussion and Analysis

June 30, 2006 and 2005

Our discussion and analysis of the New Jersey State Employees Deferred Compensation Plan (the Plan) financial performance provides an overview of the Plan's financial activities for the fiscal years ended June 30, 2006 and 2005. Please read it in conjunction with the basic financial statements and financial statement footnotes that follow this discussion.

As of January 1, 2006, Prudential Retirement was selected as the Plan's third-party administrator. The Division of Investments retains its fiduciary functions over the Plan's assets, and the Division of Pensions and Benefits maintains its administrative oversight functions.

FINANCIAL HIGHLIGHTS

2006 - 2005

- Fiduciary net assets increased by \$191,966,894 as a result of fiscal year 2006's operations from \$1,516,374,059 to \$1,708,340,953.
- Additions for the year were \$273,353,885, which is comprised of member contributions of \$166,371,405 and investment gains of \$106,982,480.
- Deductions for the year were \$81,386,991, which are comprised of benefit payments of \$80,873,250 and administrative expenses of \$513,741.

2005 - 2004

- Fiduciary net assets increased by \$163,097,929 as a result of fiscal year 2005's operations from \$1,353,276,130 to \$1,516,374,059.
- Additions for the year were \$230,746,131, which is comprised of member contributions of \$137,662,924 and investment gains of \$93,083,207.
- Deductions for the year were \$67,648,202, which are comprised of benefit payments of \$66,714,506 and administrative expenses of \$933,696.

THE STATEMENTS OF FIDUCIARY NET ASSETS AND THE STATEMENTS OF CHANGES IN FIDUCIARY NET ASSETS

This annual report consists of two financial statements: *The Statements of Fiduciary Net Assets* and *The Statements of Changes in Fiduciary Net Assets*. These financial statements report information about the Plan and about its activities to help you assess whether the Plan, as a whole, has improved or declined as a result of the year's activities. The financial statements were prepared using the accrual basis of accounting. Under the accrual basis of accounting, revenues are recognized in the period they are earned, and expenses are recorded in the year they are incurred, regardless of when cash is received or paid.

The Statements of Fiduciary Net Assets show the balances in all of the assets and liabilities of the Plan at the end of the fiscal year. The difference between assets and liabilities represents the Plan's fiduciary net assets. Over time, increases or decreases in the Plan's fiduciary net assets provide one indication of whether the financial health of the Plan is improving or declining. *The Statements of Changes in Fiduciary Net Assets* show the results of financial operations for the year. The statements provide an explanation for the change in the Plan's fiduciary net assets since the prior year. These two financial statements should be reviewed along with the information contained in the financial statement footnotes to determine whether the Plan is becoming financially stronger or weaker.

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FINANCIAL ANALYSIS

SCHEDULE OF FIDUCIARY NET ASSETS

2006- 2005

	2006	2005	Increase (Decrease)
Assets	\$1,709,246,862	\$1,523,707,914	\$185,538,948
Liabilities	905,909	7,333,855	(6,427,946)
Net Assets	\$1,708,340,953	\$1,516,374,059	\$191,966,894

Total assets increased by \$185.5 million or 12.2% between fiscal years 2005 and 2006 primarily due to an increase in fair values of investments and an increase in membership in the Plan.

Total liabilities decreased by \$6.4 million or 87.7% mainly due to a decrease in participant distribution payable.

Net assets increased by \$192.0 million or 12.7%.

2005 - 2004

	2005	2004	Increase (Decrease)
Assets	\$1,523,707,914	\$1,358,993,334	\$164,714,580
Liabilities	7,333,855	5,717,204	1,616,651
Net Assets	\$1,516,374,059	\$1,353,276,130	\$163,097,929

Total assets increased by \$164.7 million or 12.1% between fiscal years 2004 and 2005 primarily due to increase in fair values of investments.

Total liabilities increased by \$1.6 million or 28.3% mainly due to increase in participant distribution payable.

Net assets increased by \$163.1 million or 12.1%.

ADDITIONS TO FIDUCIARY NET ASSETS

2006 - 2005

	2006	2005	Increase (Decrease)
Member Contributions	\$166,371,405	\$137,662,924	\$28,708,481
Investment & Other	106,982,480	93,083,207	13,899,273
Totals	\$273,353,885	\$230,746,131	\$42,607,754

Additions primarily consist of member contributions and earnings from investment activities. Total revenues increased by \$42.6 million or 18.5% between fiscal year 2005 and 2006 because of an increase in membership and also an increase in net appreciation in fair value of investments.

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2005 - 2004

	2005	2004	Increase (Decrease)
Member Contributions	\$137,662,924	\$129,545,400	\$8,117,524
Investment & Other	93,083,207	146,635,689	(53,552,482)
Totals	\$230,746,131	\$276,181,089	\$(45,434,958)

Total revenues decreased by \$45.4 million or 16.5% between fiscal year 2004 and 2005 primarily because of decrease in net appreciation in fair value of investments.

DEDUCTIONS FROM FIDUCIARY NET ASSETS

2006 - 2005

	2006	2005	Increase (Decrease)
Benefits	\$80,873,250	\$66,714,506	\$14,158,744
Administrative Expenses	513,741	933,696	(419,955)
Totals	\$81,386,991	\$67,648,202	\$13,738,789

Deductions consist of benefit payments and administrative expenses during the year. Total expenses increased by \$13.7 million or 20.3% between fiscal year 2005 and 2006. The increase in expenses is mainly due to an increase in benefit payments to an increased number of retirees.

2005 - 2004

	2005	2004	Increase (Decrease)
Benefits	\$66,714,506	\$58,415,128	\$8,299,378
Administrative Expenses	933,696	809,953	123,743
Totals	\$67,648,202	\$59,225,081	\$8,423,121

Total expenses increased by \$8.4 million or 14.2% between fiscal year 2004 and 2005. The increase in expenses is mainly due to increase in number of hardship distribution.

RETIREMENT SYSTEM AS A WHOLE

Members are 100% vested in the present value of their contributions.

CONTACTING SYSTEM FINANCIAL MANAGEMENT

The financial report is designed to provide our members, beneficiaries, investors and other interested parties with a general overview of the Plan's finances and to show the Plan's accountability for the money it receives. If you have any questions about this report or need additional financial information, contact the Division of Pensions and Benefits, P.O. Box 295, Trenton, NJ 08625-0295.

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Statements of Fiduciary Net Assets

June 30, 2006 and 2005

	2006	2005
Assets:		
Cash	\$ —	130,241
Investments at fair value:		
Cash Management Fund	187,257,616	342,723,902
U.S. Government obligations	368,107,830	185,878,456
Domestic equities	1,045,975,946	956,868,107
International equities	56,476,302	—
Other fixed income securities	42,962,011	34,569,950
	<u>1,700,779,705</u>	<u>1,520,040,415</u>
Receivables:		
Accrued interest	1,538,464	2,606,823
Accrued dividends	676,040	943,742
Participant contributions	—	(13,307)
Other	6,252,653	—
	<u>8,467,157</u>	<u>3,537,258</u>
Total investments	<u>1,709,246,862</u>	<u>1,523,707,914</u>
Liabilities:		
Participant distributions payable	87,110	6,660,337
Administrative fees payable	752,417	673,518
Cash Overdraft	66,382	—
	<u>905,909</u>	<u>7,333,855</u>
Net Assets:		
Held in trust for benefits	<u>\$ 1,708,340,953</u>	<u>1,516,374,059</u>

See accompanying notes to financial statements.

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Statements of Changes in Fiduciary Net Assets

Years ended June 30, 2006 and 2005

	2006	2005
Additions:		
Member contributions	\$ 166,371,405	137,662,924
Investment income:		
Net appreciation in fair value of investments	68,304,659	59,555,956
Interest	22,967,212	17,621,147
Dividends	15,923,578	16,113,875
	107,195,449	93,290,978
Less : investment expense	212,969	207,771
Net investment income	106,982,480	93,083,207
Total additions	273,353,885	230,746,131
Deductions:		
Benefits	80,873,250	66,714,506
Administrative expense	513,741	933,696
Total deductions	81,386,991	67,648,202
Change in net assets	191,966,894	163,097,929
Net assets - Beginning of year	1,516,374,059	1,353,276,130
Net assets - End of year	\$ 1,708,340,953	1,516,374,059

See accompanying notes to financial statements.

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(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of accounting

The financial statements of the New Jersey State Employees Deferred Compensation Plan (the Plan) have been prepared using the accrual basis of accounting and conform to the provisions of Government Accounting Standards Board (GASB) Statements No. 25, "Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans," and Statement No. 32, "Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans."

Valuation of Investments

Investments are reported at fair value as follows:

- U.S. Government and Agency and Corporate obligations – prices quoted by a major dealer in such securities.
- Common Stocks – closing prices as reported on the primary market or exchange on which they trade.
- Money Market Instruments – amortized cost which approximates fair value.
- Cash Management Fund – closing bid price on the last day of trading during the period as determined by the Transfer Agent.

Investment Transactions

Investment transactions are accounted for on a trade date basis. Gains and losses from investment transactions are determined by the average cost method. Interest and dividend income is recorded on the accrual basis, with dividends accruing on the ex-dividend date.

Administrative expenses

Expenses associated with the Plan, which include but are not limited to administrative and investment costs, are charged against the Plan's net assets as determined by the action of the New Jersey State Employees Deferred Compensation Board (the Board). The fee is charged to participants' accounts on a monthly basis. Amounts charged against the net assets by the Plan to date have exceeded the payments made, the excess of which has been recorded as administrative fees payable.

Unit valuation

Participants' net asset value per unit is determined on a monthly basis for each of the Plan's four investment fund options. Net asset value per unit is computed on the total fair value at the end of the month of the Plan's net assets divided by the total outstanding units of the Plan.

(2) DESCRIPTION OF THE PLAN

The following description of the Plan provides only general information. Participants should refer to the Plan information statement, which is available from the State of New Jersey, Division of Pensions and Benefits, for a more complete description of the Plan's provisions.

General

The Plan was established by Chapter 39, P.L. 1978, which became effective June 19, 1978, amended by Chapter 449, P.L. 1985, effective January 14, 1986, and by Chapter 116, P.L. 1997, effective June 6, 1997, and is available to any state employee who is a member of a state-administered retirement system or an employee of

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an eligible state agency, authority, commission or instrumentality of state government provided the employee has at least 12 continuous months of employment, and any individual employed through a Governor's appointment. The Plan's membership was 37,496 and 34,414 at June 30, 2006 and 2005, respectively.

The assets of the Plan are being held in trust for the exclusive benefit of Plan members and their beneficiaries as required by Internal Revenue Code Section 457.

Prudential Retirement was selected as the Plan's third-party administrator following a competitive bidding process with a contract awarded on August 26, 2005. As of January 1, 2006, the four state-managed investment options (DCP Money Market, DCP Equity, DCP Bond and DCP Small Cap Equity) were closed to new investment and 23 new investment options were opened. Participant recordkeeping operations were transferred to Prudential Retirement on January 2, 2006. Assets held in the four state-managed investment options were transferred to Prudential separate accounts on February 1, 2006. The custodian of Plan assets was PNC Bank through January 31, 2006, with State Street Bank acting as custodian, through an agreement with Prudential Retirement, from February 1, 2006 to present. The Division of Investments retains its fiduciary functions over the Plan's assets and the Division of Pensions and Benefits maintains its administrative oversight functions.

Contributions

Participants may defer between 1% and 100% of their salary, as defined, and less any 414h reductions or \$15,000 annually. Under the limited "catch-up" provision, a participant may be eligible to defer up to a maximum of twice the annual maximum in the three years immediately preceding the retirement age at which no reduction in benefits would be applicable. Participants must defer at least 1% of their annual salary but no less than \$10 biweekly or \$20 monthly. Federal income taxes are not due on deferred amounts or on any accumulated earnings until the participant receives a distribution of assets. Participants may elect to invest their contributions in multiples of 1% in any of the four investment fund options, and may increase, decrease or suspend their deferrals once a month. Compensation amounts deferred and accumulated earnings thereon, while in trust for the exclusive benefit of the participants, remain the property of the State of New Jersey until distributed to participants. Participants are always fully vested for the accumulated units in their accounts. Participation in the Plan ceases at retirement, termination of service, disability or death.

Participants' accounts

The administrator maintains a bookkeeping account for each participant that is credited as of the date at which the participant's compensation is deferred.

The account is also credited with any increase or charged with any decrease related to the transactions of the Plan.

The State of New Jersey is only under a contractual obligation to make payments under this Plan in accordance with the provisions of the applicable statute as payments become due. The State of New Jersey is not a guarantor of the Plan.

Distribution of assets

A participant of the Plan or beneficiary may receive a distribution of assets under the Plan upon the participant's retirement, termination of service, disability, or death. Distribution of the participant's account will be made in a single lump-sum payment within two months after the administrator is notified of the event for all accounts unless the participant elects to delay distribution from the Plan. In all cases, distribution must commence no later than 90 days following the close of the calendar year in which the participant retired, terminated service, became disabled, died or attained age 70½, whichever is later. If the value of the participant's account is at least \$5,000, the participant may choose distribution as a lump-sum payment or, in substantially equal installments over a period not to exceed fifteen years. Additionally, the participant may select a combination payment consisting of

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an initial lump-sum payment followed by installments over a period not to exceed fifteen years if the balance in the account following the initial lump-sum payment is at least \$5,000. Accounts are valued for distribution purposes as of the end of the month immediately preceding distribution.

Distribution is also permitted in the case of an unforeseen emergency, as defined by Internal Revenue Code 457 regulations. A participant may also elect to receive an in-service distribution if the participant has not made deferrals into the Plan for 24 consecutive months and the total value of the participant's account does not exceed \$5,000.

Termination of the Plan

The Board, in accordance with the provisions of Chapter 39, P.L. 1978, has the authority to terminate this Plan or to substitute a new plan consistent with the requirements of the United States Internal Revenue Service.

Upon termination, each participant shall be deemed to have withdrawn from the Plan as of the date of such termination; the participant's full compensation on a non-deferred basis will be restored; and the administrator shall treat such participants as if they had termination of service on the date of such termination and pay such deferred compensation in accordance with provisions of the Plan.

Any substitute of a new plan, consistent with the requirements of the United States Internal Revenue Service, shall provide for the retention by the employer of the amounts already deferred under the prior plan and for the distribution of said amounts in accordance with the irrevocable written elections made pursuant to the Plan.

(3) INVESTMENTS

The Plan's investments as of June 30 are as follows:

	<u>2006</u>	<u>2005</u>
Cash management funds	\$ 187,257,616	342,723,902
U.S. Government and Agency obligations	368,107,830	185,878,456
Domestic equities	1,045,975,946	956,868,107
International mutual funds	56,476,302	—
Other fixed income securities	42,962,011	34,569,950
	<u>\$ 1,700,779,705</u>	<u>1,520,040,415</u>

New Jersey state statute provides for a State Investment Council (Council) and a Director. Investment authority is vested in the Director of the Division and the role of the Council is to formulate investment policies. The Council issues regulations which establish guidelines for permissible investments which include domestic common and preferred stocks and issues convertible into common stock, obligations of the U.S. Treasury, government agencies, corporations, finance companies and banks, New Jersey State and Municipal general obligations, public authority revenue obligations, commercial paper, certificates of deposit, repurchase agreements, bankers acceptances, guaranteed income contracts and money market funds.

The Plan's investments are subject to various risks. Among these risks are credit risk, concentration of credit risk and interest rate risk. Each one of these risks is discussed in more detail below.

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The credit risk of a debt instrument is measured by nationally recognized statistical rating agencies such as Moody's Investors Service, Inc. (Moody's) or Standard & Poor's Corporation (S&P). Concentration of credit risk is the risk of loss attributed to the magnitude of an investment in a single issuer. With respect to equities, not more than 10 percent of the market value of the Equity or Small Capitalization Equity accounts can be invested in any one

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corporation. There are no restrictions in the amount that can be invested in United States treasury and government agency obligations. Not more than 10% of the market value of the Fixed Income Account can be invested in the debt of any one corporation, and not more than 10% of any one issue may be purchased at the time of issue.

Council regulations require minimum credit ratings for certain categories of fixed income obligations and limit the amount that can be invested in any one issuer as follows:

<u>Category</u>	<u>Minimum Rating</u>		<u>Limitation of Issuer's Outstanding Debt</u>	<u>Other Limitations</u>
	<u>Moody's</u>	<u>S&P</u>		
Corporate obligations	Baa	BBB	25%	—
U.S. finance company debt, bank debentures and NJ state & municipal obligations	A	A	10%	—
Public Authority revenue obligations	A	A	—	Not more than 2% of fund assets can be invested in any one public authority
Collateralized notes and mortgages	Baa	BBB	—	Limited to not more than 10% of the assets of the portfolio
Commercial paper	P-1	A-1	—	—
Certificates of deposit/ Banker's acceptances (rating applies to international)	Aa/P-1	—	—	Uncollateralized certificates of deposit and banker's acceptances cannot exceed 10% of issuer's primary capital
Guaranteed income contracts	P-1	—	—	A+ rating from A.M. Best Co. for insurance companies
Money market funds	—	—	—	Not more than 10% of fund assets can be invested in money market funds; limited to 5% of shares or units outstanding

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For securities exposed to credit risk in the fixed income portfolio, the following table discloses aggregate fair value, by major credit quality rating category at June 30, 2006 and 2005:

June 30, 2006	Moody's Rating							
	Aaa	Aa	A	B	Ba	Baa	P	Not Rated
US Treasury Notes	\$ 155,439,939	140,351	—	—	—	—	—	32,989
US Treasury TIPS	7,261	—	—	—	—	—	—	—
Federal Farm Credit Banks	874,375	—	—	—	—	—	—	—
Federal Home Loan Mortgage	26,065,993	—	—	—	—	—	—	—
FNMA Debentures	83,986,241	—	—	—	—	—	28,764	—
Corporate Bond	8,936,929	24,203,652	21,485,118	2,843	345,367	27,879,524	—	3,650,898
Finance Company Debentures	869,015	29,104	118,443	—	—	—	149,959	62,527
FHLM Collateralized Notes	8,048,603	—	—	—	—	—	—	—
GNMA	5,749,938	—	—	—	—	—	—	—
Other	40,431,955	361,083	303,930	(42)	5,451	282,761	55,627	1,521,244
Total	<u>\$ 330,410,249</u>	<u>24,734,189</u>	<u>21,907,491</u>	<u>2,801</u>	<u>350,818</u>	<u>28,162,285</u>	<u>234,350</u>	<u>5,267,658</u>

June 30, 2005	Moody's Rating		
	Aaa	Aa	A
U.S. Treasury notes	\$ 99,317,295	—	—
U.S. Treasury TIPS	5,070,064	—	—
Federal Farm Credit Banks	7,025,690	—	—
Federal Home Loan Mortgage	26,469,825	—	—
FNMA debentures	38,416,500	—	—
Corporate bonds	—	9,846,500	9,882,200
Finance company debentures	—	14,841,250	—
FHLM collateralized notes	9,579,082	—	—
Total	<u>\$ 185,878,456</u>	<u>24,687,750</u>	<u>9,882,200</u>

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment. Council regulations provide limitations in the amounts that can be invested in fixed income securities maturing more than 12 months from date of purchase for finance company debt and New Jersey state and municipal general obligations. Commercial paper must mature within 270 days. Certificates of deposits and bankers acceptances are limited to a term of one year or less. The maturity of repurchase agreements shall not exceed 15 days. The investment in a guaranteed income contract is limited to a term of 10 years or less.

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The following table summarizes the maturities of the fixed income portfolio at June 30, 2006 and 2005:

June 30, 2006	Total Fair Value	Maturities in Years			
		Less than 1	1-5	6-10	More than 10
U.S. Treasury Notes	\$ 155,613,278	9,987,685	133,220,263	7,210,141	5,195,189
U.S. Treasury TIPS	7,261	—	—	1,963	5,298
Federal Farm Credit Banks	874,375	—	874,375	—	—
Federal Home Loan Mortgage	26,065,993	—	23,586,915	1,972,074	507,004
FNMA Debentures	84,015,005	3,116,564	79,057,010	327,217	1,514,215
Corporate Bond	86,504,330	2,159,288	48,987,666	25,456,738	9,900,638
Finance Company Debentures	1,229,047	194,862	560,885	117,678	355,622
FHLM Collateralized Notes	8,048,603	—	—	189	8,048,414
GNMA	5,749,938	—	5,749,938	—	—
Other	42,962,011	705,129	34,477,112	5,464,652	2,315,118
Total	\$ <u>411,069,841</u>	<u>16,163,528</u>	<u>326,514,163</u>	<u>40,550,652</u>	<u>27,841,498</u>

June 30, 2005	Total Fair Value	Maturities in Years			
		Less than 1	1-5	6-10	More than 10
U.S. Treasury notes	\$ 99,317,295	13,619,813	69,760,582	15,936,900	—
U.S. Treasury TIPS	5,070,064	—	5,070,064	—	—
Federal Farm Credit Banks	7,025,690	7,025,690	—	—	—
Federal Home Loan Mortgage	26,469,825	4,005,000	22,464,825	—	—
FNMA debentures	38,416,500	15,161,775	23,254,725	—	—
Corporate bonds	19,728,700	4,961,600	9,846,500	4,920,600	—
Finance company debentures	14,841,250	4,982,250	9,859,000	—	—
FHLM collateralized notes	9,579,082	—	—	—	9,579,082
Total	\$ <u>220,448,406</u>	<u>49,756,128</u>	<u>140,255,696</u>	<u>20,857,500</u>	<u>9,579,082</u>

The Cash Management Fund is unrated. The Cash Management Fund is not evidenced by securities that exist in physical or book entry form held by the Plan.

(4) INCOME TAX STATUS

Based on a 1986 declaration of the Attorney General of the State of New Jersey, the Plan is an eligible plan as described in Section 457 of the Internal Revenue Code. The Plan operates within the terms of the Plan and remains eligible under the applicable provisions of the Internal Revenue Code.