NRRIT

National Railroad Retirement Investment Trust

Annual Management Report for Fiscal Year 2002

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Required by Public Law 107-90,
The Railroad Retirement and Survivors' Improvement Act of 2001

Annual Management Report of the

National Railroad Retirement Investment Trust

For the Fiscal Year Ended September 30, 2002

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Introductory Statement

The first year of any start-up organization is always a challenging one, and for the National Railroad Retirement Investment Trust ("NRRIT" or the "Trust"), the first year has been challenging and exciting. From the 21st of December 2001, when President Bush signed into law the Railroad Retirement and Survivors' Improvement Act of 2001 (Public Law 107-90) (the "Act"), rail management and rail labor worked closely together to bring the new Trust into existence. On the day it was officially established under the Act, the Trust became one of the largest pension investment trusts in the United States.

On February 1, 2002, the Board of Trustees of the NRRIT (the "Board of Trustees" or "the Trustees") met for the first time, with participation by three appointees of rail management and three appointees of rail labor. The initial challenges were organizational: acceptance by the Trustees of their positions, notification to the Railroad Retirement Board, selection of a chair, adoption of bylaws, retention of counsel, and acquisition of insurance and bonding coverages. During the next eight months, the Trustees met in person for 16 day-long meetings, and conducted 10 additional meetings via conference call.

After the broad outline of an entity began to take shape in late February, the Board of Trustees turned its attention to the fundamental investment issues including: a nationwide search for the statutorily mandated independent trustee, recruitment of a chief investment officer, and the development of investment guidelines. As part of this process, the Trustees and industry experts met with senior investment professionals from some of the country's largest corporate pension plans and Taft-Hartley plans to explore a variety of investment and organizational issues.

By early summer, various aspects of the structure had come together: the independent trustee had been selected, and the Trust had hired its first full time employee, the Chief Investment Officer ("CIO"). At this juncture, the Board of Trustees turned to development of the statutorily mandated investment guidelines. On a parallel track, the Trustees selected the Trust's first investment manager to begin restructuring the Trust's government securities portfolio into a more diversified blend of equity and fixed income securities.

Although the initial transfer of funds from the U.S. Treasury to the Trust for investment did not occur until the middle of September, the first fiscal year of the Trust that ended on September 30, 2002 was a full and eventful year. This report outlines the year's activities in more detail. In addition, the report includes highlights of investment activities and other organizational developments that have occurred in the first few months of the current fiscal year in order to provide a more detailed overview of the Trust's first 12 months of operation. During the October-December 2002 period, significant transfers of assets from the U.S. Treasury to the Trust were completed. Given the unique nature of this transitional period, the Trustees believe that it is appropriate and informative to include a section on this activity in the Annual Report for fiscal year 2002.

LEGISLATIVE HISTORY

The National Railroad Retirement Investment Trust was established by P.L. 107-90, The Railroad Retirement and Survivors' Improvement Act of 2001.

The Act was the culmination of a multi-year process that began with discussions between the railroad unions and management in the late 1990s. In January 2000, rail management and a majority of rail unions reached an agreement in principle as to jointly supported changes to the Railroad Retirement Act of 1974. These changes included provisions relating to both railroad retirement benefits and the financing of those benefits.

The agreement was presented to the congressional committees of jurisdiction in both the U.S. House of Representatives and in the U.S. Senate. Following extensive discussions and some modifications to the original proposal, H.R. 4844, the Railroad Retirement Survivors' and Improvement Act was introduced in the U.S. House of Representatives on July 13, 2000 by the bipartisan leadership of the House Committee on Transportation and Infrastructure and the House Committee on Ways and Means, with the full support of rail management and most of the railway labor unions. Section 105 of H.R. 4844 provided for the establishment of an independent, non-governmental trust to invest the assets of the railroad retirement system.

The legislation was approved by both House committees in July 2000 (H. Rept. 106-777, Parts 1 & 2), and was considered and passed by the U.S. House of Representatives by a vote of 391-25 on September 7, 2000. The legislation was subsequently favorably reported by the Senate Committee on Finance (Senate Rept. 106-475, October 3, 2000), but not considered by the Senate prior to the adjournment of the 106th Congress. The bill was reintroduced in the 107th Congress on March 21, 2001 by the bipartisan leadership of the House Committee on the Transportation and Infrastructure as H.R. 1140. This legislation was identical to the House-passed version of the legislation from the previous Congress. H.R. 1140 was favorably reported by the Committee on Transportation and Infrastructure on May 16, 2001 with various technical changes (H. Rept. 107-82, Part 1.) The bill was sequentially referred to the Committee on Ways and Means for a period ending July 12, 2001. This Committee did not act on the legislation during this referral period. Some additional refinements to H.R. 1140, as it had been reported from the Committee on Transportation and Infrastructure on May 16, 2001, were added to the bill by the Chairman of the Committee on Transportation and Infrastructure prior to House consideration on July 31, 2001. On that date, as further amended, the legislation was passed by the House on the Suspension Calendar by a vote of 384-33.

H.R. 1140 was sent to the Senate, where ultimately it was considered as a floor amendment to unrelated legislation, H.R. 10. After several days of Senate debate, H.R. 10 (with language identical to House-passed H.R. 1140) passed the Senate on December 5, 2001 by a vote of 90-9. The House of Representatives concurred in the Senate amendment to H.R. 10, on December 11, 2001, clearing the legislation for signature by the President. The Railroad Retirement and Survivors' Improvement Act of 2001, was signed into law by President George W. Bush on December 21, 2001.

Pursuant to the Act, the Trust became effective on the first day of the month that began more than 30 days after enactment -- February 1, 2002.

IMPLEMENTATION PROCESS

Initial Administrative Operations

Implementation Task Force

In the 41 days between enactment and the Trust's establishment date of February 1, 2002, a labor-management implementation task force worked to create this new entity. The group included representatives of all major railroads and several railway labor unions. In addition, this task force called on the expertise of a variety of senior executives from industry to provide advice on legal, investment, treasury functions, insurance, and human resources issues. The task force provided recommendations regarding the outline of a basic organizational structure for consideration by the new Board of Trustees when they first convened on February 1. The task force and its investment and administrative working groups met in person or via telephone conference 13 times during this period. In addition, the task force met and coordinated closely with representatives of the U.S. Railroad Retirement Board (the "RRB") on various start-up issues.

While the task force was preparing recommendations for the Board of Trustees to consider when it was constituted on February 1, 2002, railway labor unions and rail management selected the initial six trustees pursuant to the Act. Labor organizations, representing more than two-thirds of all active employees covered under railroad retirement, met and selected the following trustees: Joel Parker, International Vice President, Transportation Communications Union, for the three-year term; Daniel E. Johnson, III, General Secretary and Treasurer, United Transportation Union, for the two-year term; and George J. Francisco, Jr., President of the National Conference of Firemen and Oilers - SEIU, for the one-year term. Carriers employing more than two-thirds of all active employees covered under the Act selected the following Trustees: Thomas N. Hund, Executive Vice President and Chief Financial Officer, Burlington Northern Santa Fe Corporation, for the three-year term; James A. Hixon, Senior Vice President-Administration, Norfolk Southern Corporation, for the two-year term; and Bernie Gutschewski, Vice President-Taxes, Union Pacific Corporation, for the one-year term. Biographical information on each Trustee is included in the Appendices.

February - May 2002: "Start-Up"

The Board of Trustees convened for the first time on February 1, 2002 to address key structural and operational issues. The first item on the agenda was for each of the six initial Trustees to formally accept his position on the Board of Trustees and to acknowledge his fiduciary obligations to the Trust. Copies of the documents evidencing the Trustees' acceptance of their positions, as well as the Board of Trustees' letter to the RRB notifying RRB that the Trust was operational, are included in the Appendices. These and all other documents executed during Board meetings are retained with the minutes of the corresponding meeting in the Trust's minute book.

The Board of Trustees designated two law firms, Dewey Ballantine LLP and Guerrieri, Edmond, & Clayman, P.C., to serve as co-counsel to the Trust. In consultation with counsel, the Trustees were able to build on the work of the implementation task force to fulfill several of their statutorily mandated responsibilities at the organizational meeting. For example, pursuant to the Act, the Board of Trustees approved and adopted Bylaws of the Trust. Among other things, the Bylaws define the Trust's fiscal year (October 1-September 30), provide for a principal office in Washington, D.C., and set forth operating rules for the time, place and conduct of meetings. A copy of the Bylaws is included in the Appendices. Subsequently, the Board of Trustees approved and adopted internal policies on administrative issues, including a Conflicts of Interest Statement of Policy and a Disclosure of Investment Information Policy. Copies of these policies are included in the Appendices.

In accordance with the Trust's Bylaws, the Board of Trustees appointed Joel Parker as its Chair and appointed the following Trustees to chair the Board's standing committees: James A. Hixon (Investment Committee), Bernie Gutschewski (Administrative Committee), and Thomas Hund (Audit Committee). Each chairman was appointed to serve a one-year term. The following Trustees agreed to serve as members of the standing committees, also for one-year terms: (i) Investment Committee: George J. Francisco, Jr., Bernie Gutschewski, Thomas N. Hund, Daniel E. Johnson, III, Joel Parker, and John W. MacMurray (as of May 15, 2002); (ii) Administrative Committee: James A. Hixon and Joel Parker; and (iii) Audit Committee: George J. Francisco, Jr., Daniel E. Johnson, III, and John W. MacMurray (as of May 15, 2002).

In consultation with Aon Risk Services, and following a competitive bidding/evaluation process, the Board of Trustees selected the Federal Insurance Company (a member of The Chubb Group of Insurance Companies) as the provider of Trustee fiduciary liability insurance coverage.

Many of the remaining challenges confronting the Board of Trustees during the Trust's "start-up" phase were substantially completed by the end of the Trust's first fiscal year. Perhaps the most important of all was the selection of the statutorily mandated Independent Trustee. At a Board meeting in February 2002, the Trustees decided to request proposals from the nation's five leading executive search firms to assist with the selection of the Independent Trustee. Following interviews with these firms, the Board of Trustees retained Russell Reynolds Associates to lead this effort. After reviewing 29 qualified candidates and interviewing several of the most qualified for the position, the Board of Trustees unanimously selected John W. MacMurray as the Independent Trustee. Mr. MacMurray assumed his position at the May 15, 2002 Board meeting and will serve until February 1, 2005. Mr. MacMurray's biographical information, acceptance of the position, and letter setting forth the terms of his retention (including compensation) are included in the Appendices.

May-June 2002

With the Trust's organizational structure and full Board of Trustees in place, the Trustees turned their attention to selection of an independent auditor for its initial fiscal year. After reviewing proposals from four major national accounting firms and conducting follow-up interviews, the Trustees selected Deloitte & Touche as the Trust's independent auditor in June 2002. As required by statute, the Deloitte & Touche audit report is included in this Annual Report.

The Board of Trustees also retained Russell Reynolds Associates to assist with the recruitment and selection of the CIO. Following review of numerous candidate applications and interviews with eight candidates in May and June 2002, Enos T. Throop, Jr. was hired effective August 1, 2002 as the Trust's first CIO. Mr. Throop brings to this position more than 25 years of investment experience. Biographical information on Mr. Throop is included in the Appendices.

Late Summer/Fall 2002

During the search process for a CIO, the Board of Trustees recognized that the Trust would need expert advice regarding human resources and benefits-related matters. Drawing on the expertise of one of the rail carriers and with the assistance of an independent benefits broker/consultant, the Trustees developed a benefits package for the CIO and other employees of the Trust, including a 401(k) plan, health care benefits, and life and disability coverage.

Since its inception, the Trust has used the facilities of one of its legal counsel, Dewey Ballantine LLP, for Trustee meetings and for temporary offices for Trust personnel without charge to the Trust. The law firm has also served as executive secretariat of the Trust during this start-up period, managing all legal, organizational and administrative matters during this initial phase. With the retention of the CIO and development of its staff plan, the Trust has begun the transition of day-to-day administrative matters to the Trust staff. In addition, the Trustees directed the CIO to conduct a search for office space for the Trust. A real estate broker and a space planner have been engaged to identify suitable office space, and to determine an efficient space plan design to meet the Trust's needs. It is intended that office space be centrally located in downtown Washington, D.C. within reasonable proximity of public transportation facilities. A number of potential spaces have been reviewed, and the selection of a preferred location is expected shortly. Move-in is targeted for July 1, 2003, subject to contract finalization and completion of construction work.

Initial Investment Operations

While creating an organizational structure, the Trustees also worked to establish an investment apparatus in a prudent and deliberative manner. Early in the process, the Board of Trustees met with leaders of some of the largest corporate and Taft-Hartley pension funds in the United States, soliciting their advice on staffing and advisor structures, investment philosophies, and implementation strategies.

In February, the Board of Trustees discussed the various requirements for outside advice and agreed that, as a first priority, the Trustees should retain a consulting firm to conduct a detailed asset-liability study of the railroad retirement system. The goal was to assess the Trust's projected funding obligations and alternative approaches to asset allocation in order to facilitate the development of statutorily mandated investment guidelines. After a thorough interview and review process, the Board of Trustees selected Watson Wyatt & Company to perform the asset-liability modeling study ("ALM study"). The ALM study was an interactive process lasting several months. The Trustees approved a final version of the ALM study in August 2002. The ALM study analyzed the projected liabilities of the Trust, the risk and return correlation of various asset classes, as well as the expected return and risk of various portfolios of these asset classes. Upon completion of the ALM study, the Trustees were in a position to finalize a specific set of investment guidelines for the Trust. The Act authorizes the Trust to diversify the investment of railroad retirement system assets into a portfolio similar to defined benefit plans of other U.S. industries.

In accordance with these statutory directives, the Trustees turned their attention to developing investment guidelines with the following principal objectives: (i) to ensure the timely and certain payment of benefits to eligible railroad retirement plan participants and beneficiaries, and (ii) to achieve a long term rate-of-return on assets sufficient to enhance the financial strength of the Railroad Retirement System. After considerable review, the Trustees formally adopted Investment Guidelines (the "Guidelines") for the Trust on August 21, 2002. The Trustees recognized that it would be impossible to immediately diversify the Trust's assets into the full array of asset classes set forth in the Guidelines in a prudent and cost-efficient manner. Thus, diversification would need to be undertaken systematically, with a view toward achieving the Guidelines' target allocation over a reasonable time period. The ratios of Trust assets invested in the various asset classes will be maintained within the target ranges outlined in the Guidelines. The Guidelines provide rules for rebalancing the Trust's portfolio when appropriate, engaging investment managers and advisers, and measuring performance. A copy of the Investment Guidelines is included in the Appendices.

Concurrent with development of the Guidelines, a subgroup of the Board of Trustees, including both Trustees and senior professional personnel from industry experienced in the evaluation of treasury function issues, with the assistance of Watson Wyatt & Company, conducted an intensive search process to select the Trust's master custodian institution. This process began with a formal request for proposals, followed by interviews and on-site visits with the finalists. The Board of Trustees retained Northern Trust as the Trust's master custodial institution pursuant to a resolution dated July 19, 2002. Negotiations with Northern Trust culminated in a Master Custody Agreement executed in August 2002.

Once the CIO was selected, the Investment Guidelines were in place, and the Trust's custodial institution was retained, the Board of Trustees, with the assistance of Watson Wyatt & Company, completed its search for an investment manager to begin the investment process to implement the Guidelines. After careful consideration and interviews with some of the largest index managers in the industry, the Board retained Barclays Global Investors ("BGI") as the Trust's initial investment manager, pursuant to an Investment Management Agreement executed in September 2002.

Coordination with Federal Government Agencies

Throughout its first fiscal year, the Trust maintained regular communications with the Railroad Retirement Board, the Department of Treasury, and the Office of Management and Budget ("OMB"). Pursuant to discussions with these agencies, the Trust became a party to a four-way Memorandum of Understanding (the

"MOU") outlining the budgetary, transfer, accounting, and financial reporting responsibilities respecting assets held by the Trust and assets held within the Treasury for the Trust. *Inter alia*, the MOU requires the Trust to report on a monthly basis: receipt and disbursement of funds, purchases and sales of assets, earnings and losses on investments, value of investments held, and administrative expenses incurred. A copy of the MOU is included in the Appendices.

OPERATIONS OF THE TRUST

Investment Structure and Staffing

With the retention of a Chief Investment Officer in August 2002, the Board of Trustees began the process of developing an investment infrastructure to enable the receipt and management of railroad retirement assets for investment. Key to this process was the selection of a custodian bank to provide custody of the Trust's assets, the establishment of the MOU to provide the procedure to transfer assets from the U.S. Treasury to the Trust and account for these transfers, and the retention of an investment manager to invest the Trust's assets.

The Trustees determined that the use of indexation was an appropriate first step to diversify the portfolio. In addition to providing broad investment exposure in the major asset classes designated in the Investment Guidelines, indexation provides significant benefits to the Trust in terms of low management fees, reduced administrative costs and low transition expense.

Operating expenses are much lower with passive management or indexation than with active management. Administrative costs are reduced because indexation is achieved through the use of a large commingled investment fund which provides significant economies of scale and, therefore, savings in the areas of accounting, custody, transaction activity, management, and reporting. Transition expenses – the cost of moving from cash into indexed investments – are low at large index managers because of the large volume of transaction activity. BGI, one of the largest investment managers in the U.S., with more than $700 billion of assets under management, provides the Trust with the additional opportunity to participate in unit exchange and share-cross transactions which involve either little or no transaction cost.

Indexation also requires a relatively low level of management oversight which afforded the CIO, the Trust's only employee in fiscal year 2002, time to devote to other, early stage, operational responsibilities of the Trust.

The CIO has developed an organizational staff plan designed to move the Trust's investment program beyond the initial indexation stage. The plan is based on the development of an in-house team of investment professionals who will be responsible for the development, implementation, and management of the investment plan for Trust assets (through the use of external active management) in different asset classes, using various strategies and methodologies.

The objective of the program is investment through the use of additional qualified external managers selected for their ability to add value relative to indexation within acceptable limits of risk. In addition to the CIO, the investment team will consist of investment professionals with specific responsibilities for investment strategy, external manager due diligence and evaluation, risk management, performance measurement and attribution analysis, and monitoring compliance with investment guidelines of the Trust. A small number of additional personnel will be responsible for Trust administrative activities. It is anticipated that the Trust's total staff will be approximately 15.

NRRIT investment staff members are expected to have earned their MBA degree and to be working toward or to have achieved the CFA designation and/or to have accumulated equivalent knowledge and experience in the investment workplace suitable for Trust responsibilities, depending on their position. Grace A. Ressler joined the Trust as Senior Administration Officer on October 1, 2002 and Catherine A. Lynch will be joining the Trust on February 1, 2003 as Senior Investment Officer. The process is currently underway to recruit additional qualified personnel.

Investment Activities and Performance

Prior to the Act, railroad retirement assets were managed by the RRB and held in three separate accounts: the Railroad Retirement Account, the Social Security Equivalent Benefit("SSEB") Account, and the Railroad Retirement Supplemental Account. The Act provided for the transfer of funds held in these accounts to the Trust for management and investment.[1]

Although the Trust began operations on February 1, 2002, the Trustees determined that it would not be prudent to transfer monies and begin investment until appropriate policies and procedures were in place. With the adoption of the Investment Guidelines, the development of the MOU, the establishment of a contractual relationship with a custodian bank, and the selection of the first investment manager, the Trust was positioned to begin the transfer of monies for investment on September 13, 2002. In accordance with procedures established in the MOU, monies transferred for investment are received by the Trust's custodian, Northern Trust. Except for small amounts which

1 Under the Act, the RRB will transfer to the Trust balances in the SSEB Account not needed to pay current benefits and administration expenses. SSEB Account balances transferred to the Trust may be used only for payment of benefits or the purchase obligations of the United States that are backed by the full faith and credit of the United States.

may be retained at the custodian to pay administrative expenses, all monies received at Northern Trust for investment by the Trust are transferred initially into restructuring accounts managed by BGI, the Trust's investment manager, for eventual investment in specific index funds selected by the Trust. Monies in the restructuring account are gradually invested directly into the target index funds or components of the target index funds as market conditions permit. When the investments in the restructuring account fully replicate the target index funds, they are exchanged via a sales transaction for investment units directly in the funds. During fiscal year 2002, approximately 7 percent (on a cash basis) of railroad retirement assets was transferred to the Trust.

The Trust received its first transfer of $1.5 billion for investment on September 18, 2002.[2] These funds were transferred from the Railroad Retirement Account and the Railroad Retirement Supplemental Annuity Account to Northern Trust and then to BGI for investment.[3] A second transfer of $1.5 billion was received on October 3, 2002, just after the close of the fiscal year. However, BGI began investing these funds on September 30, 2002, the last day of the fiscal year, in accordance with standard settlement procedures. Therefore, as of fiscal year end, while the Trust had received $1.5 billion in cash assets, its investment portfolio totaled $3.0 billion at cost, with the second transfer of $1.5 billion accounting for the balance of the total.

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[2] The Trust received $2 million in March 2002 to fund administrative expenses only.

[3] Transaction activity actually began on September 13, 2002, three business days before the settlement date coinciding with this asset transfer. As a result, September 13, 2002 is NRRIT's formal inception date for performance measurement purposes.

Other than $1 million from the second transfer of funds, which was retained at Northern Trust for the payment of administrative expenses, these monies were invested in the designated restructuring accounts by BGI during fiscal year 2002 and ultimately exchanged (sold) to the target index fund.

Northern Trust accounts for all assets received by the Trust and calculates investment performance of those assets. For the 17-day period from September 13 to the end of fiscal year 2002 (September 30, 2002) during which NRRIT had investment responsibility for those railroad retirement assets transferred to it, Northern reports that there was a decline of 5.3 percent in the market value of Trust assets. This decline is attributable to falling stock prices during the latter part of September as the Trust began to diversify into equity investments. Overall during fiscal year 2002, the market value of the total railroad retirement assets, including NRRIT investments, increased $1.4 billion after benefit payments due in large part to significant increases in the market value of railroad retirement investments in Federal securities as interest rates declined during the year.

Account Benefits Ratio

The total funds available to pay railroad retirement benefits and administrative costs include assets held in the Railroad Retirement Account and assets held by the Trust. This is reflected in section 204 of the Act, which requires that assets from these sources be included in the calculation of the account benefits ratio ("ABR"). The ABR is the ratio of the fair market value of the assets in the Railroad Retirement

Account and the Trust as of the close of the fiscal year to the total benefits and expenses paid in that fiscal year. The average account benefits ratio ("AABR"), the 10-year average of the ABR, will be used to determine the tier II tax rates for calendar years beginning 2004. Specific tier II tax rates are mandated in the Act through 2003.

According to estimates provided by the RRB,[4] for fiscal year 2001, the ABR was 6.95. This means that, as of the end of the year, there were sufficient assets to pay almost seven years of railroad retirement program benefits and administrative costs. For fiscal year 2001, the AABR was 5.50. For fiscal year 2002, the ABR was 6.20, and the AABR was 5.70.[5] SSEB Account balances, not needed to pay tier I benefits, are considered to be assets of the railroad retirement system available to fund tier II benefits. These balances were included in the ABR calculations only for fiscal years prior to 2002 because it was assumed that all surplus SSEB balances would be transferred to the Trust in the first fiscal year after enactment.[6] The SSEB Account balance was not transferred to the Trust during fiscal year 2002; therefore, these assets could not be included in that fiscal year's ABR calculation. Had these assets been included, the ABR for fiscal year 2002 would have been 6.77. The AABR would have been 5.70.

4 ABR and AABR figures are preliminary estimates provided by the Railroad Retirement Board. The final computation and certification of account benefits ratios will be made by the Railroad Retirement Board on or before November 1 of each year, beginning November 1, 2003, as provided by statute.

5 A chart summarizing the Account Benefits Ratio data is contained in the Appendices.

6 As part of the initial investment strategy, the first priority for the Trust was to begin the diversification of its portfolio from 100 percent investment in government fixed income securities to a portfolio with a blend of equity and fixed income securities. As such, the initial transfers of assets from the government accounts were focused on assets that could be invested in equity securities. Also, the Trustees had determined to begin the transfer of the SSEB Account assets, in the context of the implementation of the Trust's fixed income investment plan in early 2003, after the initial diversification into equity index accounts was substantially completed.

Thus, in terms of the total reserves available to pay railroad retirement benefits, including SSEB Account balances, the financial position of the Railroad Retirement system remained relatively stable, with the benefit reserve dipping slightly from 6.95 years[7] to 6.77 years during fiscal year 2002. The ten-year average of benefit reserves increased from 5.50 to 5.70 years. Fiscal year 2002 performance is attributable primarily to an increase in value of certain securities held within the Railroad Retirement Account during the fiscal year as interest rates declined.

Investment Activities through December 2002

In accordance with the Schedule of Cash Transfers established in the MOU, NRRIT has continued to receive periodic transfers of railroad retirement assets for investment since September 30, 2002. As of calendar year-end, the Trust had received a total of $9.75 billion, approximately 45 percent of assets eligible for transfer. These funds have been invested by the Trust in the target BGI index funds, previously described.

By transferring a small amount of total assets periodically, the Trust is able to dollar cost average its investments over an extended time period. This investment process can be beneficial, especially in a market environment as experienced in recent months where share prices have fluctuated up and down, but have displayed no clear price trend.

[7] The 6.95 years benefit reserve at the end of fiscal year 2001 is the highest level of reserve in the history of the Railroad Retirement system.

With the exception of approximately 3 percent ($700 million) of railroad retirement assets, which the RRB has indicated it intends to retain as a reserve amount, all eligible assets are expected to be transferred to NRRIT for investment by the end of fiscal year 2003.

Internal Accounting and Administrative Controls

While the diversification, management, and performance of investments are the more visible components of Trust activities, the establishment and operation of internal accounting and administrative controls are of vital importance to the Trust in meeting its objectives. In its relationships with its custodian bank and investment manager, the Trust ensures that appropriate controls and procedures are in place for the safekeeping and proper accounting of Trust assets. All transfers to and from the Trust require written approval of two authorized personnel. Daily investment manager transaction activity is transmitted directly to the custodian bank, which provides a full accounting and performance record. Staff monitors reports from both the investment manager and the custodian to ensure accuracy. Financial data from the custodian bank forms the basis for the Trust's various reporting requirements.

The Trust also reports its financial status and activities on a monthly basis to the RRB in compliance with the MOU. This reporting responsibility requires that financial data provided by Northern Trust be reformatted to meet the financial reporting obligations of the RRB. While this responsibility involves some additional complexity, it also provides another data accuracy check by the Trust, which must fully account for the variance between the two report formats.

As defined in the Act, administrative expenses of the Trust are paid from assets of the Trust. Internal systems have been established to manage the payment and recording of administrative expenses. The Board of Trustees, through its committees, oversees the investment, administration and audit functions of the Trust.

FINANCIAL STATUS OF THE TRUST

Statement of Cash Flows

In fiscal year 2002, the Trust received two cash transfers from the Railroad Retirement Board totaling $1.502 billion. The first transfer was in March of 2002 for $2 million to fund administrative expenses. The second transfer occurred in September 2002 in the amount of $1.5 billion, and was the first transfer of funds for investment by the Trust. Administrative expenses recorded through September 30, 2002 totaled $2.1 million, and include cash expenditures of $1.6 million and accrued expenses of $0.5 million. In addition to these amounts, a prepaid expense of $0.1 million was incurred. These expenses relate primarily to start-up costs of the Trust. A detailed cash flow statement is included in the Trust's financial statements as part of the Auditors' Report.

Financial Statement

The Board of Trustees determined that it would not be prudent to transfer monies to the Trust until policies and procedures were in place and a sound infrastructure was developed to assist in the management and tracking of all Trust assets. Once these critical first steps – described in the Implementation Process section earlier in this Report – were completed, the Trustees began the gradual transfer of assets and investment of these assets in September.

The Trust's net assets as of September 30, 2002, reported in the Trust's financial statements, were $1.4 billion. The methodology for recording the assets is discussed in the Investment Performance section of this report. The Trust's Statement of Operations (included in the financial statements) reflects a net loss of $79.6 million in market value of Trust investments as of September 30, 2002 and administrative expense for the year of $2.1 million. The investment performance for the year has been discussed in an earlier section of this report.

Status of Railroad System Assets

As noted above, the total market value of railroad retirement assets available to pay benefits and expenses increased during the Trust's fiscal year 2002, from $20.7 billion to $22.1 billion. Increases in the value of Federal securities held in the Railroad Retirement Account more than offset declines in the values of the Trust's initial equity investments, resulting in a net increase of railroad retirement assets of $1.4 billion in fiscal year 2002.

FINANCIAL STATEMENTS
AND
INDEPENDENT AUDITOR'S REPORT

National Railroad Retirement Investment Trust

Financial Statements for the Period from February 1, 2002 (Date of Inception) to September 30, 2002, and Independent Auditors' Report

NATIONAL RAILROAD RETIREMENT INVESTMENT TRUST

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Deloitte
& Touche

INDEPENDENT AUDITORS' REPORT

Board of Trustees
The National Railroad Retirement Investment Trust

We have audited the accompanying statements of assets and liabilities, including the schedule of investments of The National Railroad Retirement Investment Trust (the "Trust") as of September 30, 2002, and the related statements of operations, changes in net assets, cash flows and financial highlights for the period February 1, 2002 (Date of Inception) to September 30, 2002. These financial statements and financial highlights are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such financial statements and financial highlights present fairly, in all material respects, the financial position of The National Railroad Retirement Investment Trust as of September 30, 2002, and the results of its operations, its cash flows and financial highlights for the period February 1, 2002 (Date of Inception) to September 30, 2002, in conformity with accounting principles generally accepted in the United States of America.

Deloitte & Touche LLP

December 13, 2002

NATIONAL RAILROAD RETIREMENT INVESTMENT TRUST

STATEMENT OF ASSETS AND LIABILITIES
SEPTEMBER 30, 2002
(In thousands)

ASSETS

INVESTMENT IN SECURITIES—At fair value	$ 2,919,438
CASH AND CASH EQUIVALENTS	279
OTHER ASSETS	93
Total assets	2,919,810
LIABILITIES AND NET ASSETS	
INVESTMENT SECURITIES PURCHASED—Pending settlement	1,499,000
ACCRUED EXPENSES	512
Total liabilities	1,499,512
NET ASSETS	$ 1,420,298

See notes to financial statements.

NATIONAL RAILROAD RETIREMENT INVESTMENT TRUST

STATEMENT OF OPERATIONS
PERIOD FROM FEBRUARY 1, 2002 (DATE OF INCEPTION) TO SEPTEMBER 30, 2002
(In thousands)

INCOME:	
Interest	$ 7
Total Income	7
EXPENSES:	
Investment management fees	4
Operating expenses:	
Professional fees	1,787
Insurance	180
Trustee fees and expenses	130
Other expenses	46
Total Expenses	2,147
NET EXPENSE	(2,140)
NET REALIZED AND UNREALIZED LOSS FROM INVESTMENT SECURITIES:	
Net realized loss	(69,643)
Net unrealized depreciation	(9,919)
Net loss on investment securities	(79,562)
NET DECREASE IN NET ASSETS RESULTING FROM OPERATIONS	$ (81,702)

See notes to financial statements.

NATIONAL RAILROAD RETIREMENT INVESTMENT TRUST

STATEMENT OF CHANGES IN NET ASSETS
PERIOD FROM FEBRUARY 1, 2002 (DATE OF INCEPTION)
TO SEPTEMBER 30, 2002
(In thousands)

INCREASE (DECREASE) IN NET ASSETS	
Operations:	
Net expense	$ (2,140)
Net realized loss from investment securities	(69,643)
Net unrealized depreciation on investment securities	(9,919)
Net decrease in net assets resulting from operations	(81,702)
Net assets transferred to the Trust	1,502,000
NET ASSETS:	
February 1, 2002 (Date of Inception)	-
September 30, 2002	$ 1,420,298

See notes to financial statements.

NATIONAL RAILROAD RETIREMENT INVESTMENT TRUST

STATEMENT OF CASH FLOWS
FOR THE PERIOD FROM FEBRUARY 1, 2002 (DATE OF INCEPTION) TO SEPTEMBER 30, 2002
(In thousands)

CASH FLOWS FROM OPERATING ACTIVITIES:	
Net decrease in net assets resulting from operations	$ (81,702)
Adjustments to reconcile net decrease in net assets from operations to net cash generated from operating activities:	
Purchase of investment securities	(2,999,000)
Increase in assets transferred to the Trust	1,502,000
Increase in other assets	(93)
Increase in accrued expenses	512
Increase in investment securities purchased, pending settlement	1,499,000
Unrealized depreciation of investment securities	9,919
Net realized losses from investment securities	69,643
Net cash provided by operating activities	81,981
INCREASE IN CASH AND CASH EQUIVALENTS	279
CASH AND CASH EQUIVALENTS—February 1, 2002 (Date of Inception)	-
CASH AND CASH EQUIVALENTS—September 30, 2002	$ 279

SUPPLEMENTAL SCHEDULE OF NON-CASH ACTIVITIES

Exchange of units in BGI Restructuring Accounts for units in BGI Index Funds
(total value of units exchanged $1,429,847)
See notes to financial statements.

NATIONAL RAILROAD RETIREMENT INVESTMENT TRUST

SCHEDULE OF INVESTMENTS
SEPTEMBER 30, 2002
(In thousands)

Description	Number of Units	Fair Value
BGI U.S. Equity Market Fund (cost, $986,122)	24,614	$ 985,328
BGI U.S. Equity Market Restructuring Account (cost, $1,038,836)	108,051	1,038,811
BGI World Equity Index Fund ex-U.S. (cost, $443,725)	76,409	434,686
BGI World Equity Index ex-U.S. Restructuring Account (cost, $460,674)	48,058	460,613
		$ 2,919,438

See notes to financial statements.

NATIONAL RAILROAD RETIREMENT INVESTMENT TRUST

NOTES TO FINANCIAL STATEMENTS
FOR THE PERIOD FROM FEBRUARY 1, 2002 (DATE OF INCEPTION) TO SEPTEMBER 30, 2002

1. ORGANIZATION

Formation—The Trust was created as a result of Federal legislation. The Railroad Retirement and Survivors' Improvement Act of 2001 (the "Act") established the National Railroad Retirement Investment Trust (the "Trust"), the sole purpose of which is to manage and invest industry-funded Railroad Retirement assets as set forth in the Act. Domiciled in, and subject to the laws of the District of Columbia (to the extent not inconsistent with the Act), the Trust is a tax-exempt entity that is neither an agency nor instrumentality of the Federal Government. The Trust became effective on February 1, 2002.

The Railroad Retirement system was created as a Federal pension program during the 1930s to fund retirement benefits of railroad workers and their dependents. For more than 65 years, the Railroad Retirement system has collected payroll taxes from railroad employers and employees and paid out benefits to beneficiaries. Railroad Retirement is funded as a pay-as-you-go system that is not subject to Employee Retirement Income Security Act of 1974 ("ERISA") funding rules.

The Act authorizes the Trust to manage and invest the assets of the Railroad Retirement system in the same array of investment options available to private sector pension plans, and to pay administrative expenses of the Trust from the assets in the Trust. Prior to the Act, Railroad Retirement assets were limited to investment in U.S. Government securities directly with the United States Treasury (the "Treasury"). Responsibility for administering the Railroad Retirement system, including eligibility determinations and the calculation of beneficiary payments, remains with the Railroad Retirement Board (the "Board"), a Federal agency.

Investment Management—At the outset, the Trust selected Barclays Global Investors ("BGI") as investment manager to invest the Railroad Retirement assets the Trust receives from the Board. The investment manager is directed by the Trust to invest assets into each of two equity indexed portfolios: one targeting U.S. equity investments and the other non-U.S. equity investments. Monies to be invested are first contributed to BGI restructuring accounts, one for each target index fund. In turn, the Trust receives units of the restructuring accounts representing the total value of the contribution. Gradually, and as market conditions permit, those monies are invested directly into securities structured to match, as closely as practicable, the holdings and returns of the target index. The units of the restructuring account are priced daily to reflect the changing composition of the account. When the assets of the restructuring account are fully invested in securities of the target index, they are transitioned into the target index fund, and simultaneously exchanged for units of the target index fund. While this transition avoids the actual sale and repurchase of securities in the open market and eliminates all trading costs, any unrealized gain or loss that has accrued in the restructuring account since the securities were originally purchased, is realized.

2. SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting—The financial statements of the Trust are prepared on the accrual basis of accounting, in accordance with accounting principles generally accepted in the United States. The Trust follows the accounting principles for an investment company for purposes of financial reporting.

Investment Securities—The Trust records purchases and sales of investment securities on a trade-date basis. Investment securities are recorded at stated fair market value. Gains or losses realized on sales of investment securities are based on average cost.

Income Taxes—The Trust is exempt from taxes under Section 501(c)(28) of the Internal Revenue Code of 1986.

Cash and Cash Equivalents—For purposes of reporting cash flows, cash and cash equivalents include interest earning deposits held at banks and cash balances held in a short-term investment fund which can be withdrawn upon same day notice.

Investment Management Fees—Fees are paid to the investment management firm on a quarterly basis and are calculated as a percentage of the average market value of assets managed using a time-weighted method. The Trust did not receive assets for investment until the fourth quarter of fiscal year 2002. For the fourth quarter, investment management fees were 0.0035 % of the time weighted average asset balance. Investment management fees amounting to $4,217 as of September 30, 2002 have been accrued and are reflected as investment management fees on the accompanying statement of operations.

3. RELATED PARTY TRANSACTIONS

Railroad Retirement Board—Under the provisions of the Act, the Board directs the Treasury to transfer Railroad Retirement Account assets and other assets as defined in the Act to the Trust. During fiscal year 2002, $1.502 billion of these Railroad Retirement assets were transferred to the Trust. As defined in the Act, the Trust reports to the Board and is required to perform its duties solely in the interest of the Board and through it, the participants and beneficiaries of the programs funded by the Act.

Legal Counsel—The Trust incurred $1.3 million in legal fees in fiscal year 2002, which were primarily related to the formation of the Trust. Legal counsel was provided by firms that may also provide services to the major railroads and railway labor unions whose representatives are members of the Board of Trustees. Since its inception, the Trust has used the facilities of one of its legal counsel, Dewey

Ballantine LLP, for Trustee meetings and for temporary offices for Trust personnel without charge to the Trust. The law firm also served as executive secretariat of the Trust during this start-up period, managing all legal, organizational and administrative matters during this initial phase.

4. EMPLOYEE BENEFIT PLANS

The Trust provides a defined contribution plan ("Plan") covering all employees. Employees participate in the Plan by making discretionary contributions from their eligible compensation, but not more than the maximum annual amount allowed by law. The Trust makes matching contributions equal to 100% up to 3% of compensation and 50% on the next 2% of compensation. No matching contributions were made in the current fiscal year.

5. FINANCIAL HIGHLIGHTS

In accordance with the American Institute of Certified Public Accountants ("AICPA") Audit and Accounting Guide, *Audits of Investment Companies*, using the methods prescribed in the related AICPA Technical Practice Aids, the following financial highlights are being disclosed for the period from February 1, 2002 (Date of Inception) to September 30, 2002.

In March 2002, the Trust received $2 million from the Treasury, at the direction of the Board, for the funding of administrative expenses. In September 2002, the Trust received an additional $1.5 billion from the Treasury, at the direction of the Board, for investment in securities. The financial ratios noted below encompass all funds received by the Trust through September 30, 2002. Due to the short operating period and minimal investment activity in its first year of operation, the Trust's financial ratios listed below may be of limited value. These ratios are expected to provide more valuable information in future years as additional funds are transitioned to the Trust, and they are calculated on a full operating year basis. As such, the ratios shown below have not been annualized.

Financial Ratios (1): Not annualized (calculated for the period February 1, 2002 through September 30, 2002)

Expenses to net assets	.15%
Net investment loss to net assets	(5.6)%

Total Return (2): Not annualized (calculated for the period from September 13, 2002 to September 30, 2002)

Total return	(5.3)%

(1) The ratios of expenses to net assets and net investment loss to net assets represent the expenses and net investment loss for the period of February 1, 2002 (Date of Inception) to September 30, 2002, as reported on the statement of operations, to the Trust's net assets at the end of the period, September 30, 2002, and are not

annualized. Total expenses relate primarily to costs incurred by the Trust during inception.

(2) The total return reflected above is the return on the assets transferred by the Board to the Trust for investment. The return covers only the period of time the assets were invested, from September 13, 2002 to the September 30, 2002, and is not annualized. Total return measures the change in asset value plus income and realized gains or losses.